Module-1: Accounting: An Introduction

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Objective

The objective of this module is to introduce concepts of financial accounting such as basics of accounting rules, branched of accounting, accounting equation and knowledge of Generally Accepted Accounting Principles.

Outcome

At the end of this module, learner will be able to-

1. Understand the meaning and significance of accounting.
2. Explain sub-fields of accounting.
3. Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
4. Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

"The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting"

According to American Accounting Association (Year 1966)-

1.1 Introduction

Business is an economic activity conducted to earn profits and increase the wealth of the owner. Business rules are based on general principles of trade social values and the national or international boundaries legal framework. While these variables the vary for different companies and regions, the basic goal is to add value to the product or service in order to satisfy customer demand

Through reporting all transactions related to the development of monetary inflows of sales revenue and monetary outflows of operating expenses, a business accounting system ensures an accountability.

The accounting system provides the financial information needed to assess the efficacy of both current and past activities. The accounting system also provides the data required to file reports that show the status of a business entity's borrower liabilities, ownership equities and asset capital.

1.2 What is Accounting?

All of us do some accounting, often without realizing it. It is a part of out life. Let us say you realize suddenly, one morning, that you need to buy a book urgently. You ask your parents for the money. "But" the parent asks, as to "What happened to the money you were given last week?" You either recollect how you spent it or if you believe in being systematic and have noted it in your diary you explain as to how the money was spent.

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You are 'accounting' for the money given to you. When a homemaker tries to note down her household expenses, she either strikes the balance she has on hand at the end of the month, or determines how much she needs for the expenses which would arise. She is thus accounting for the money she withdrew or was given to run the household.

In business, however, it is a more urgent matter. A student may not be questioned by his parents or a homemaker may just meet her expenses as and when they come without bothering to find out how much she spent, but in business it is a must. You cannot run a business unless you know how much you owe outsiders and how much outsiders owe you. And when you invest money in a business as an owner wouldn't you like to know whether you've recovered it, increased it or lost it?

1.3 Definition of Accounting

Definition by the American Institute of Certified Public Accountants (Year 1961):

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof".

Definition by the "The Accounting Principles Board" (APB) of the AICPA (Year 1970):

—Accounting is a service activity .Its function is to provide information primarily financial in nature about economic entities that is intended to be useful in making economic decisions.‖

With the help of above definitions, we can draw out following attributes of accounting:-

- ***Recording:*** Involves the reporting of financial transactions in an orderly manner, immediately after their occurrence in the proper account books.
- Classifying:- Involves systematic analysis of data recorded, in order to collect transactions of a similar type at one place. This role is accomplished by managing the ledger in which different accounts are opened to which relevant transactions are reported.
- ***Summarising:*** Involves the planning and delivery of the classified data in a way that would be helpful to users. The function includes preparing financial statements, like income statement, balance sheet, financial position adjustment statement, cash flow statement, value added statement, etc.
- ***Interpreting:*** Technology advancement helps the electronic data processing tools to perform three tasks that are being recorded, categorized and summarized. One of the key goals of maintaining accounts periodically is to view data that is subjective and can differ from person to person.The accounts clarify not only what has occurred but also as to why it has happened and a future forecast as well.

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1.4 Nature of Accounting

Accounting is the systematic recording of financial transactions and presentation of the related information of the appropriate persons. The basic features of accounting are as follows:

1. ***Accounting is a Process:*** A process refers to the step-by-step method of performing any specific job according to the goals or target. Accounting is identified as a process performing specific task of collecting, processing and communicating the financial data. This is accompanied by certain steps such as the data tracking compilation, description summarization, finalisation, and publishing.
2. ***Accounting is an Art***: Accounting is art of recording, classifying, summarizing and finalizing the financial data. The word −art refers to the way something is performed. It is knowledge of behaviour involving certain skills and creativity that can help attain specific goals.

1.5 Objectives and Scope of Accounting

Accounting has a very broad scope and area of operation. It is not limited only to the business world but is distributed throughout all facets of society and all occupations. Nowadays, financial transactions must take place in any social institution or professional practice, whether that is income generating or not. Therefore the need to record and summarize these transactions as they occur emerges and there is a need to figure out the net result of the same after the expiry of a certain fixed period.

- ***To keep systematic records***: Accounting is performed to keep a systematic record of financial transactions. The primary objective of accounting is to help collect financial data and to record it systematically for the derivation of correct and useful results of financial statements.
- ***To ascertain profitability***: With the help of accounting, the profits and losses incurred during a specific accounting period can be evaluated. With the help of a Trading and Profit& Loss Account, the profit or loss of a firm can be easily determined.
- ***To ascertain the financial position of the business:*** A balance sheet or a statement indicates the financial position of a Company as on a particular date. A properly drawn balance sheet gives us an indication of the value of assets, the nature and value of a liability, and also the capital position of the firm. Thus, the soundness of any business entity can be easily ascertained.
- ***To assist in decision-making***: To take decisions for the future, there is a need for accurate financial statements. One of the main objectives of accounting is to take the right decisions at the right time. Thus, accounting gives the platform to plan for the future with the help of past records.
- ***To fulfill law compliance***: Business entities like organizations, trusts, and societies are being run and governed according to different legislative acts. Similarly, different taxation laws (direct-indirect tax) are also applicable to every business house. It is requires to keep and maintain various types of accounts and records as prescribed by corresponding laws of the land. Accounting helps in running a business in compliance with the law.

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1.6 Branches of Accounting

Accounting is an old science that aims at keeping records of various transactions. Accounting is considered essential for record-keeping of all the receipts and payments as well as the income and expenditures. Accounting can be broadly classified into three categories:

1. Financial Accounting

Financial accounting is aimed at identifying an accounting year's results in terms of profits or losses and assets and liabilities. To do this it is important that numerous transactions are documented systematically. Financial accounting is characterized as an art and science of systematically classifying, analyzing and reporting business transactions in order to prepare a report at the end of the year to assess the details of the related year.

Financial accounting involves the following terms -

- Business Transactions: A business transaction is any activity that creates a kind of legal relationship. For example, the purchase and sale of goods, appointing an employee and paying salary, payment of various expenses, purchase of assets, etc.
- Classification of Transactions: Before recording any transaction, it is essential to classify it. A transaction can be classified as a cash and credit transaction. Similarly, transactions of receiving income and expenditure payment can be segregated.
- Recording of Transactions: The essence of financial accounting is the recording of transactions. In accounting terms, recording of the transaction is known as entry, and there are specific rules for recording various transactions in books of accounts.

2. Cost Accounting

Cost accounting is intended to capture a Company's production costs by assessing the input costs for each production phase, as well as fixed costs such as depreciation of an equipment. Cost accounting must analyze and record these costs independently first, and then compare the results with expected or measurable outcomes to help the Company assess financial performance. Cost accounting is often used within a Company to facilitate decision-making, and financial management is typically seen by the investor's external community. Cost accounting can also be useful in budgeting and setting up cost control systems as a method for management, which can increase the Company's net profits in the long run.

3. Management Accounting

Management accounting is the application of professional knowledge and skills for the preparation and presentation of accounting information in such way that assists the management in the formulation of policies and also in planning and controlling the operations of the organization. The main purpose of management accounting is to provide information to the management team at all levels within the organization for the following purposes:

(a) Formulating the policies—strategic planning

(b) Planning the activities of the organization—corporate planning

(c) Controlling the activities of the organization

(d) Decision-making—long-term and tactical

(e) Performance appraisals at strategic and operational level - A management accounting/cost statement provides information to allow managers to plan, control and organize the activities of the business.

The purpose of a costing/management accounting information system is:

1. Provide information about the cost of the product to be used in financial statements.

2. Provide information for planning, organizing and controlling.

1.6.1 Difference between Management Accounting and Financial Accounting

S.no	Management Accounting	Financial Accounting
1	Management Accounting is primarily based on the data available from Financial Accounting	Financial Accounting is based on the monetary transactions of the Company.
2	Reports prepared in Management Accounting are meant for management and as per management requirement.	Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
3	It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making	Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
4	Reports may contain both subjective and objective figures.	Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5	Reports are not subject to statutory audit.	Reports are always subject to statutory audit.
6	It evaluates the sectional as well as the entire performance of the business.	It ascertains , evaluates and exhibits the financial strength of the whole business

1.7 Book Keeping

As defined by Carter, 'Book-keeping is a science and art of correctly recording in books of accounts, all the business transactions resulting in the transfer of money or money's worth'. Book-keeping is an activity concerned with recording and classifying financial data related to business operation as per the order of its occurrence. Book-keeping is a mechanical task that involves -

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- The collection of basic financial information.
- Identification of events and transactions with a financial character i.e., economic transactions.
- Measurement of economic transactions in terms of money.
- Recording financial effects of economic transactions as per its order of occurrence.
- Classifying the effects of economic transactions.
- Preparing organized statement known as trial balance.

1.7.1 Difference between Book keeping and Accounting

S.n	Book Keeping	Accounting
1	Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence	Purpose of accounting is to find results of operating activity of business and to report financial strength of business.
2	Output of book-keeping is an input for accounting.	Output of accounting permit informed judgments and decisions by the user of accounting information
3	Book-keeping is a foundation of accounting.	Accounting is considered as a language of business.
4	Book-keeping is carried out by junior staff	Accounting is done by senior staff with skill of analysis and interpretation.
5	Objects of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	Object of accounting is not only bookkeeping but also analyzing and interpreting reported financial information for informed decisions.

1.8 Generally Accepted Accounting Principles

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are known as Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements.

GAAP is a mix of standards set by the government bodies and essentially the commonly accepted methods of collecting and presenting information on accounting. Organizations are to follow GAAP so that investors have an optimal level of consistency in the financial statements they use when evaluating firms for investment purposes. GAAP covers the aspects like revenue recognition, balance sheet items classification and outstanding share measurements.

1.8.1 Accounting Concepts and Conventions

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Accounting principles are the basic guidelines which set standards for scientific accounting practices and procedures. They guide as to how to record and report the transaction and also guarantee uniformity and understandability. The accounting standards lay the foundations for the principles of accounting.

Such principles ensure that financial facts are documented on solid foundations, and rational criteria. Accounting Conventions are widely accepted approaches or procedures. We follow the Conventions as transactions are registered or interpreted. The terms-principles, definitions and conventions are however used interchangeably at times.

A. Basic Assumptions

(a) **Business Entity Concept** - This concept explains how distinct the business is from its owner. Thus, business transactions are to be recorded in the business books only.

For example, a business should pay its debts and file its own income tax return. The owner is required to file their income tax return that is separate from the business return. The property or assets that a business owns must be recorded separately from the property that the owner of the business has.

Significance

The significance of business entity concept is :

- The concept helps in the ascertainment of the profit of business as only the business expenses and revenues are recorded and all the other private and personal expenses are ignored.
- The concept restraints the accountants from recording of the owner's private and personal transactions.
- Facilitates the recording and reporting of the business transactions from the point of view of business.
- It is the very basis of accounting concepts, conventions, and principles.

(b) **Going Concern Concept** - When a business is started, the operations are intended to last for some time or continue. It does not intend to go into bankruptcy or instantly dissolve. It expects to be able to meet its responsibilities to its consumers or partners, to offer goods or services. The business often continues, even when the ownership changes.The concept assumes that the business has a perpetual succession or continued existence.

For example, a Company purchases a plant and machinery of Rs.2,00,000 with a life span of 10 years. According to the concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. In the year of purchase, only a part of the value is shown as expense and the remaining balance is shown as an asset.

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Significance

The significance of the going concern concept the following:

- The concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on fixed asset.
- It is of great help to the investors, as it assures, that there will be a continuous income on their investments.
- The cost of a fixed asset will be treated as an expense in the year of its purchase in the absence of the concept.
- A business is accurately judged for its capacity to earn profits in future.

(c) **Money Measurement Concept** – The concept assumes that all business transactions must be in terms of money that is in the currency of a country. In our country the transactions are in terms of rupees. Thus, according to this concept only those transactions which are expressed in money terms are to be recorded in the books of accounts.

For example, sale of goods worth Rs. 2,50,000 purchase of raw materials Rs.1,00,000 Rent Paid is Rs.10,000 etc. are expressed in terms of money. Thus, they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts.

For example, loyalty, sincerity and the honesty of employees are not recorded in books of accounts as they are immeasurable in terms of money, although they do affect the profits and losses of the business concern.

Significance

The following points highlight the significance of the money measurement concept:

- The concept guides accountants as to what to record and what not to record.
- It helps in recording the business transactions uniformly.
- If all the transactions are represented in monetary terms, the accounts prepared by the business Company will be easy to understand.
- This enables the comparison of two different periods of business performance of the same Company or of the two different companies for the same duration.

(d) **The Accounting Period Concept** – According to the concept, all the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. Thus, the concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is relevant for various purposes such as income calculation, financial position ascertainment, tax calculation etc. Furthermore, the concept assumes that infinite business life is divided into parts. These sections are called the Accounting Period. It may be of one year, six months or three months etc, but usually one year is taken as one accounting period which can be either a calendar year or a financial year.

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Significance

- It helps in the prediction of future prospects of a business.
- It helps in the calculation of tax on the business income that is calculated for a particular time period.
- It also helps the banks, financial institutions, creditors, etc. to assess and analyze the performance of a business for a particular time period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

(e) **The Accrual Concept** – Accrual means something which becomes due, especially an amount of money that is yet to be paid or received at the end of an accounting period. This also means that revenues are recognized when they become receivable. The accrual concept is based on the recognition of both cash and credit transactions. In case of a cash transaction, the owner's equity is instantly affected as cash either is received or paid. In a credit transaction, a mere obligation towards or by the business is created. When credit transactions exist, the revenues are not the same as cash receipts and expenses are not same as cash paid during the period. Thus, the concept makes a distinction between the accrual receipt of cash and the right to receive cash.

For example, a firm sells goods for Rs 50,000 on 20th March 2008 and the payment is not received until 10th April 2008, the amount is due and payable to the firm on the date of sale i.e. 20th March 2008. It must be included in the revenue for the year ending 31st March 2008.

Significance

- It helps in the determination of actual expenses and actual income during a particular time period.
- It helps in the calculation of the net profit of the business.

B. Basic Principles

(a) **Realization Concept** – The concept emphasizes on recording of only those transactions which are actually realized. For example, the sale or profit on sales will be taken into account only when money is realized, i.e., either cash is received or legal ownership is transferred.

Example:

Mr. A sold goods for Rs.1,00,000 for cash in 2020 and the goods have been delivered during the same year. Thus, The revenue for Mr. A for year 2019 is Rs.1,00,000 as the goods have been delivered in the year 2019. Cash has also been received in the same year.

Significance

- It makes the accounting information more objective.
- It provides that, transactions must be recorded only when goods are delivered to the buyer.

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(b) **Matching Concept** - It is referred to as matching of expenses against incomes. The concept states that all incomes and expenses relating to the financial period to which the accounts relate should be taken in to account without regarding the date of receipts or payment.

Significance

- Guides on how to balance expenditures with revenue to calculate exact profit or loss for a given period.
- Helpful for the investors or the shareholders for determining the exact amount of profit or loss of the business.

(c) **Full Disclosure Concept**: According to the concept, all significant information must be disclosed. For the purpose of presenting the financial statements that are useful to accounting information users, accounting details should be adequately described, summarized, aggregated, and explained. In practice, this concept underlines the materiality, objectivity and accuracy of accounting data which should show a true and fair view of a firm's state of affairs.

(d) **Duality Concept**: According to this concept each transaction has two aspects, i.e. the aspect of benefit receiving and the aspect of benefit giving. Such two factors are to be identified in the account books.

For example, goods purchased for cash has two aspects -

(i) Giving of cash

(ii) Receiving of goods. These two aspects are to be recorded.

The duality concept is expressed in terms of fundamental accounting equation as –

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of the owner and the outsiders. The claim is also termed as capital or owners' equity and that of outsiders, as liabilities or creditors' equity.

(e) **Verifiable Objective Concept** – As per this concept, the accounting data must be verified. It means the documentary proof of transactions that can be checked by an independent respect must be given. Without such assurance, the available data will neither be accurate nor correct, ie. Those details will be biased. Both verifiability and objectivity express dependability, reliability and the trustworthiness, which is useful for the purpose of displaying accounting data and information to the users.

Significance

- The concept requires assets to be shown at the price they have been acquired, which can be verified from the supporting documents.
- Helps in the calculation of depreciation on fixed assets.
- The effect of cost concept is that the item will not be shown in the account books if the business entity does not pay anything for an asset

(f) **Historical Cost Concept** - Business transactions are always recorded at the actual cost at which they are undertaken. The main advantage is that, there is an avoidance

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of the arbitrary value being attached to the transactions. Whenever an asset is acquired, it is recorded at its actual cost, and the same is used as the basis for all subsequent accounting purposes, such as charging depreciation on asset use.

For example, if production equipment is bought for Rs.2 crores, the asset will be shown at the same value in all future periods when disclosing the original cost. It will be reduced by the amount of depreciation, which will be calculated with reference to the actual cost. The actual value of the equipment may increase or decrease after the purchase but this is deemed irrelevant for accounting purposes according to the concept. The limitation of this concept is that the balance sheet does not represent the market value of the business-owned assets and therefore the owner's equity will not reflect the real value. On an ongoing basis, however, the properties are seen as reduced by depreciation at their historical prices.

(g) **Balance Sheet Equation Concept** – According to this concept, all that has been received, must be equal to that has been given. Here the receipts are clarified as debits and giving is clarified as credits.

The basic equation, appears as – Debit = Credit

Every debit must have a corresponding credit and vice-e-versa. Thus, we can write the above in the following form:

Expenses + Losses + Assets = Revenues + Gains + Liabilities

If expenses and losses, and incomes and gains are set off, the equation will be –

Asset = Liabilities or, Asset = Equity + External Liabilities

i.e., the Accounting Equation.

C. Modifying Principles

(a) **The Concept of Materiality or Full Disclosure** - Materiality can be related to information, amount, procedure and nature. According to the concept, all such information having the chance to influence financial information including the owners is relevant and must be integrated into the accounting process. Error in the description of an asset or a misclassification between capital and profits may result in information materiality.

For example, where at the end of the accounting period postal stamps of 300 remain unused, the same may not be considered for acknowledgment as an inventory on account of the materiality of the number. All accounting treatments rely on the accounting standards defined procedures. All transactions are by nature of material regardless of the amount involved, e.g. an audit fee, loan to directors.

(b) **Consistency Concept** – According to this concept, the accounting practices should not change or must remain unchanged over a period of several years. This means that the accounting principles, methods, practices, and procedures adopted in accounting process shall be applied consistently. Frequent changes in accounting methods is not desirable in accounting process, as it reduces third party acceptability of financial statements.

(c) **Conservatism Concept or Prudence** - Conservatism concept states that when alternative valuations are possible then the alternative fairly representing the

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economic substance of transactions should be selected. However, when such choice is not clear then the alternative that is least likely to overstate net assets and net income must be selected. The concept provides the best estimate for all known expenditures and losses if the sum is not known with certainty but on the basis of expectation it does not consider sales and profits.

(d) **Timeliness Concept** – According to this concept, every transaction must be recorded in proper time. It refers to the need for accounting information to be presented to the users in time to fulfill their decision making needs. In short, transaction should be recorded date-wise in the books of accounts. A delay in providing information makes it irrelevant and less useful to the decision making needs of the users. Further, a delay in recording such transaction may lead to manipulation, misplacement of vouchers; misappropriation etc. of both cash and assets.This concept is particularly followed during day-to-day cash balance verification. It is also followed by banks i.e. each bank verifies the cash balance with their cash book and must complete the same within the day.

(e) **Industry Practice** - As there are different types of industries, each industry has its own characteristics and features. There may be some seasonal industries also. Every industry follows the accounting principles and standards for carrying out its own activities. Some of them follow to the values, definitions and conventions in a modified manner. For example, the electric supply companies or the insurance companies maintain their accounts in a specific manner. Insurance companies prepare a revenue account to ascertain the profit/loss of the Company. Similarly, non-trading organizations prepare Income and Expenditure Account to find out Surplus or Deficit.

1.9 International Financial Reporting Standards

International Financial Reporting Standards (IFRSs) are set by the International Accounting Standards Board (IASB) that was established in 2001 to replace the International Accounting Standards Committee (IASC). International Financial Reporting Standards (IFRS), formerly known as International Accounting Standards (IAS) are the standards, interpretations and the framework preparing and presenting the Financial Statements adopted by the International Accounting Standards Board (IASB).

What is International Accounting Standards Board (IASB),

The IASB is the independent standard setting body of the IFRS to approve the interpretations of IFRS as developed by the IFRS Interpretations Committee. The IASB engages closely with the stakeholders globally including the investors, analysts, regulators, accounting standard setters and more. The formulation if ISB is necessary as –

- There is a recognized and growing need for the common international standards
- No individual setter has a monopoly over a best solution to the accounting standards.
- No national standard setter is in a position to set accounting standard that gain acceptance around the world.

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Steps taken by IASB for Global Convergence

1. Issued a conceptual framework - It had adopted the framework issued by IASC in 1989. The framework saves as guide to IASB for developing Accounting Standards.
2. Issue of IAS – Till now IASC had Issued 41 International Accounting Standards

IAS List	Particulars
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events After the Balance Sheet Date
IAS 1 1	Construction Contracts
IAS 1 2	Income Taxes
IAS 1 6	Property, Plant and Equipment
IAS 1 7	Leases
IAS 1 8	Revenue
IAS 1 9	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 33	Earning Per share (EPS)
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

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3. Issue of International Financial Reporting Standards (IFRS)

IAS List	Particulars
IFRS 1	First-time Adoption of IFRS
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities
IFRS 13	Fair Value Measurement

4. Setting up the IFRS Interpretations Committee

The IFRS Interpretations Committee (formerly called as the IFRIC) is the interpretative body of the IASB. The objective of the committee is to review on timely basis within the context of IAS, IFRS and the framework, accounting issues that are debatable and provide a clarification for the same.

1.10 IFRS Foundation

On 24 May 2000, IASC members approved the first constitution of the IASC foundation, and on 5 March 2002, IASC foundation trustees amended those articles, effective that date. These amendments were necessary to implement some elements of the IASB's Standing Interpretation Committee preface to IFRS.

The IFRS foundation is an independent and not for profit private sector organization that works in public interest. The principal objectives of the organization as follows –

1. The main objective of the IFRS Foundation is to establish a common set of high quality, comprehensible, enforceable and internationally agreed financial reporting standards based on clearly articulated principles for the public interest.
2. Development of a single set of high quality, understandable and a globally accepted IFRS through its standard setting body ISB.
3. Promote the use and a regular application of the principles.
4. Take into account the financial reporting needs of the emerging economies and the small and medium sized entities (SMEs)

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Key Takeaways

- ***Accounting***: Accounting is treated as the language of business. It records all the transactions which can be measured in money and have occurred in a particular period.
- ***Cost accounting***: It is intended to capture an Enterprise's production costs by assessing the input costs for each production phase, as well as fixed costs such as depreciation of an equipment
- ***Management accounting***: It is the application of professional knowledge and skills for the preparation and presentation of accounting information
- ***Account***: An account is a record used to properly classify the activity recorded in the General Ledger.
- ***Accrual Basis*** - Method of accounting that recognizes revenue when earned, rather than when collected and expenses when incurred rather than when paid. The college uses the accrual basis for its accounting.
- ***Asset***- Anything of use to future operations of business and belonging of an enterprise. An asset is what the college owns. For example- land, property, buildings, equipment, cash in bank accounts, other investments and accounts receivable.
- ***Credit*** - A credit is an entry on the right side of a double-entry accounting system that represents the reduction of an asset or expense or the addition to a liability or revenue.
- ***Debit*** - A debit is an entry on the left side of a double-entry accounting system that represents the addition of an asset or expense or the reduction to a liability or revenue.
- ***Double-Entry Accounting*** - Method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting.
- ***Expense/Costs*** - It is the expenditure incurred by enterprise to earn revenue. An expense is funds paid by the college. For example-paychecks to employees, reimbursements to employees, payments to vendors for goods or services.
- ***Equity***- It refers to total claims against enterprise. It is further dividers into Owner's Claim (Capital) and Outside's Claim (Liability).
- ***GAAP*** - GAAP stands for Generally Accepted Accounting Principles which are conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.
- ***Liability*** - A liability is what the college owes. For example-loans, taxes, payables, long term debt from a bond issue, funds held by the college for a third party such as a student group.
- ***Revenue*** - Revenue is funds collected by the college; it can also be called income. It is monetary value of products/services sold to customers during the period. For example, tuition, fees, rentals, income from investment.

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- ***Balance Sheet*** - The Balance Sheet is the statement summarizing the financial position of a business on a given date. It summaries on the right hand side the assets of the business and on the left hand side the liabilities of the business.

Check your progress

1. Accounting based on the monetary transactions of the enterprise is
   a) Management Accounting
   b) Cost Accounting
   c) Financial Accounting
   d) Absorption Accounting
2. Accounting aimed at identifying an accounting year's results in terms of profits or losses and assets and liabilities.
   a) Management Accounting
   b) Cost Accounting
   c) Financial Accounting
   d) Absorption Accounting
3. ____________________ is the language of business.
   a) Accounting
   b) Business Transaction
   c) Profits
   d) Financial Management
4. What is IASB?
   a) Indian Accounting Standards Board
   b) International Accounting Standards Board
   c) International Asset Standards Bureau
   d) Indian Asset Standards Bureau
5. The concept explaining the distinction of business is from its owner is ?
   a) Going Concern Concept
   b) Money Measurement Concept
   c) Business Entity Concept
   d) Prudence Concept

Questions & Exercises

1. Define Accounting. How is it different from Accountancy and Book-keeping?
2. Explain various steps in the process of Accounting.
3. What do you understand by Accounting Principles? Explain some of them.

4. Differentiate between management and financial accounting?
5. Explain in brief the various branches of accounting.

Check your progress:

1. c) Financial Accounting
2. c) Financial Accounting
3. a) Accounting
4. b) International Accounting Standards Board
5. c) Business Entity Concept

Further Readings

1. Accounting for Managers . Maheshwari and Maheshwari. Vikas publication.
2. Financial Accounting . Meigs and Meigs. Mcgraw Hills Inc.
3. Introduction to Accountancy. T S Grewal. S Chamd & Co Ltd
4. Advanced Accounting, Sehgal Ashok, Sehgal Deepak .Taxman Allied Services (P) Ltd., New Delhi
5. Advanced Accountancy, Jain S.P., Narang K.L..Kalyani Publishers, Ludhiana.
6. Advanced Accounts, Shukla M.C., Grewal T.S.: S. Chand & Company Ltd., New Delhi.
7. Advanced Accountancy, Gupta R.L., M. Radhaswamy: Sultan Chand & Sons, New Delhi.
8. Financial Accounting, Tulsian. Tata McGraw-Hill, New Delhi.

Notes

Module–2: Recording of Transactions

Objective

The module is intended to introduce the basic concept of double entry, accounting cycle and preparation of voucher, journal, ledger and trial balance. It includes the recording of transaction in primary and subsidiary books of accounts.

Outcome

At the end of this module, learner will be able to:

- Understand the meaning and significance of Double Entry System.
- Record transactions in the appropriate ledger accounts using the double-entry book-keeping system.
- Understand how debits and credits are determined from transactions and events.
- Observe the points to be taken care of while recording a transaction in the journal.

> ***"Accounting is the art of recording, classifying and summarizing in a significant manner and terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the result thereof"***
>
> According to the American Institute of Certified Public Accountants [AICPA]–

Introduction

Accounting is the analysis & interpretation of book keeping records. It includes not only the maintenance of accounting records but also the preparation of financial & economic information which involves the measurement of transactions & other events relating to entry.

The main object of keeping the books of accounts is to ascertain the profit or loss of business and to assess the financial position of the business at the end of the year. The object is better served if the businessman first satisfies himself that the accounts written up during the year are correct or at least arithmetically accurate. When the transactions are recorded under double entry system, there is a credit for every debit, when on a/c is debited; another a/c is credited with equal amount.

2.1.1 Concept of Double Entry System

Double Entry System It was in 1494 that Luca Pacioli the Italian mathematician first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

- Every transaction has two fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

Notes

- Every transaction is divided into two aspects, Debit and Credit. One account is to be debited and the other account is to be credited.
- Every debit must have its corresponding and equal credit.

2.1.2 Advantages of Double Entry System

- Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- Ensures an arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.
- Prevents and minimizes frauds. Moreover frauds can be detected early.
- Errors can be checked and rectified easily.
- Balances of receivables and payables are determined easily, since the personal accounts are maintained.
- Businesses can compare the financial position of the current year with that of the past years
- The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.
- It becomes easy for the Government to decide the tax and also helps the Government to decide sickness of business units and extend help accordingly.
- Other stakeholders like suppliers, banks, etc take a proper decision regarding grant of credit or loans.

2.1.3 Limitations of Double Entry System

- The system does not disclose all the errors committed in the books accounts.
- The trial balance prepared under this system does not disclose certain types of errors.
- It is expensive as it involves the maintenance of numbers of books of accounts.

2.2 The Concepts of 'Account', 'Debit' and 'Credit'

The concept of Account

An account is defined as a summarized record of transactions related to a person or a thing, for example when the business deals with customers and suppliers, each of the customers and supplier will be a separate account.

The account is also related to things – both tangible and intangible. e.g. land, building, equipment, brand value, trademarks etc are some of the things. When a business transaction happens, one has to identify the 'account' that will be affected by it and then apply the rules to decide the accounting treatment

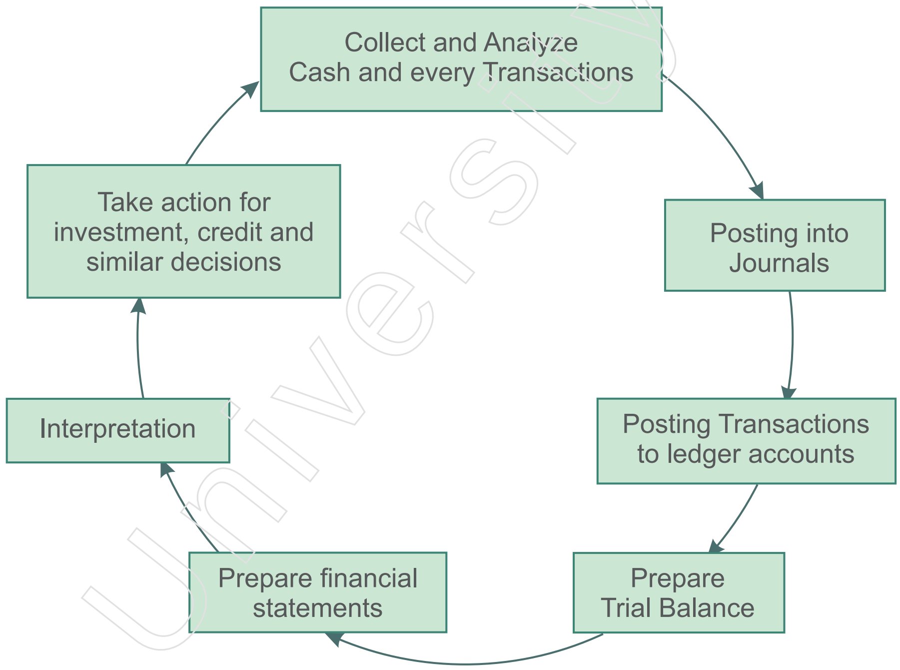
Notes

Typically, an account has two sides. The left hand side is called as "Debit' side and the right hand side is called as "Credit' side. The debit is denoted as 'Dr' and the credit by 'Cr'. The convention is to write the Dr and Cr labels on both sides as shown below.

Dr.	Cash Account	Cr.
Debit Side		Credit Side

2.3 Accounting Cycle

When a complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.



(i) Recording of Transaction: As soon as a transaction happens it is at first recorded in subsidiary book.

(ii) Journal: The transactions are recorded in Journal chronologically.

(iii) Ledger: All journals are posted into ledger chronologically and in a classified manner.

(iv) Trial Balance: After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

(v) Adjustment Entries: All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

(vi) Adjusted Trial Balance: An adjusted Trail Balance may also be prepared.

(vii) Closing Entries: All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

Notes

(viii) Financial Statements: Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

2.4 Types of Accounts

The classification of accounts and rules of debit and credit based on such classification are given below:

a) ***Personal Accounts:*** Accounts recording transactions relating to individuals or firms or Company are known as personal accounts. Personal accounts may further be classified as:

(i) ***Natural Person's personal accounts***: The accounts recording transactions relating to individual human beings e.g., Ajay's a/c, Ram's a/c, John's a/c are classified as natural persons personal accounts.

(ii) ***Artificial Person's personal accounts***: The accounts recording transactions relating to limited companies, bank, firm, institution, club, etc., Delhi Cloth Mill; M/s Singh & Singh; Ramjas College; Gymkhana Club are classified as artificial persons' personal accounts.

(iii) ***Representative Personal Accounts***: The accounts recording the expenditure and income related transactions are listed as nominal accounts. But in some situations (due to the matching accounting concept) the sum is payable to the individuals on a particular date or recoverable from individuals. Such amount -

- Relates to the particular head of expenditure or income and
- Represents people to whom it is payable or from whom it is recoverable. Such accounts are classified as representative personal accounts , for example "wages outstanding account", pre-paid Insurance account, etc.

b) ***Real Accounts***: The accounts recording transactions relating to tangible things (that can be touched, purchased and sold) like the cash, goods, building & machinery etc. are classified as tangible real accounts. Whereas the accounts recording transactions relating to intangible things (which do not have a physical form) like the goodwill, patents and copy rights, trade marks etc. are classified as intangible real accounts.

c) ***Nominal Accounts***: The account recording transactions relating to the losses, gains, expenses and incomes, for example salaries, wages, rent, commission, interest, bad debts etc. are classified as nominal accounts.

Rules of debit and credit (classification based)

1. Personal accounts: Debit the receiver Credit the giver (supplier)
2. Real accounts: Debit what comes in Credit what goes out
3. Nominal accounts: Debit expenses and losses Credit incomes and gains

Modern Approach to Accounting

Under the Modern Approach, the accounts are not debited and credited. Hence, the Accounting Equation is used to debit or credit an account. Thus, it is also known as the Accounting Equation Approach.

Notes

Modern Classification of Accounts

Types of accountq	Normal balance of account	Account to be debited when there is;	Account to be credited when there is:
Asset account	Debit	Increase	Decrease
Liabilities account	Credit	Decrease	Increase
Capital account	Credit	Decrease	Increase
Revenue account	Credit	Decrease	Increase
Expenditure account	Debit	Increase	Decrease
Drawing account	Debit	Increase	Decrease

- ***Debit Amount (Debit):*** The debit amount is recorded in the debit amount column opposite to the title of the account that is being debited.
- ***Credit Amount (Credit):*** The credit amount is recorded in the credit amount column opposite to the title of the account that is being credited.

The Basic Accounting Equation is: Assets = Liabilities + Capital (Owner's Equity)

Furthermore, it can be expanded as Assets = Liabilities + Capital + Revenues – Expenses

Also, Profit = Revenues – Expenses

a. ***Assets Accounts:*** Assets are a business's properties, possessions or economic resources. They assist in company activities and help to raise money. It is possible to calculate them in terms of revenue. Resources may be either intangible or tangible. You may also identify assets as fixed assets and current assets. For the long-term, fixed assets are retained.

b. ***Liabilities Accounts***: Liabilities are the amounts that an entity owes to the outsiders. These are the obligations or the debts payable by the business. Liabilities can also be classified as Long-term and Current.

Long-term Liabilities are payable after a period of one year. For example, debentures, bank loans, etc. Current liabilities are payable within one year. For example, creditors, bills payable, rent outstanding, bank overdraft, etc.

c. ***Capital Accounts:*** The cash brought by the investor into the corporation is called Capital or Owner's Equity. The capital may be transported by the owner in cash or properties. Capital is a corporation responsibility that needs to be paid back to the owner. Therefore, capital is shown on the liabilities side of the Balance Sheet. The capital account is shown after deducting the Drawings by the owner. Drawings are the amount of cash, goods or assets taken by the owner for personal use from the business.

d. ***Revenue Accounts***: Revenue is the amount earned by an enterprise by selling goods or rendering of services. Also, it includes other incomes such as rent and commission received, interest received, dividend earned, etc. All items of revenue are also clubbed together under the Modern Approach.

e. ***Expenses Accounts***: All costs incurred or money invested by a corporation in order to raise income are called costs. It is interesting here that it is considered an expenditure when the advantages of the money invested are exhausted within a span of one year. If the advantage lasts for more than a year, it is called investment.

Therefore, the purchase of goods is expenditure while the cost of goods sold is an expense. For example, rent paid, salary paid, electricity charges, interest paid, etc. are expenses. While the purchase of assets, purchase of short-term investments, etc. fall under the category of expenditure.

2.5 Accounting Equation

The recording of business transaction in books of accounts is based on a fundamental equation called accounting equation. Whatever business possesses in the form of assets is financed by proprietor or by outsiders. This equation expresses the equality of assets on one side and the claims of outsiders (liabilities) and owners or proprietors on the other side.

In Mathematical form = Assets = Liabilities + Capital

Or A = L + P or

P = A – L

or L = A – P

Where A = Assets, L = Liabilities, P = Capital

Example:

XYZ Ltd. is a company incorporated to carry on the business of selling juices. XYZ Ltd.'s transactions for the month of January were as follows:

Jan. 1 Issued equity shares of 20,00,000 (cash received in full).

Jan. 5 Purchased land for 5,75,000.

Jan. 8 Purchased a building for 4,40,000, paying 1,40,000 in cash and the balance payable in three monthly installments.

Jan. 15 Purchased machinery worth 2,20,000.

Jan. 20 Purchased syrup (raw material) for making soft drinks worth 5,75,000, paying 1,75,000 in cash and accepting a bill drawn by the supplier for the balance.

Jan. 25 Purchased further machinery worth 50,000.

Jan. 31 Sold cold drinks worth 50,000 (consuming 30,000 of syrup). Show the effects of the above transactions upon the accounting equation.

Notes

Solution:

(Figures are in ₹)

	Assets					Liabilities		+Capital
	Cash	Inventory	Land	Building	Machinery	Creditors	Bills Payable	
Jan. 1	(+)20,00,000					= ____		+20,00,000
Jan. 5	(-)5,75,000		+5,75,000					
Balance	14,25,000		5,75,000					
Jan. 8	(-) 1,40,000		____	+ 4,40,000		= +3,00,000		
Balance	12,85,000		5,75,000	4,40,000		= 3,00,000		20,000,00
Jan. 15	(-) 2,20,000			____	+2,20,000	= ____		
Balance	10,65,000		5,75,000	4,40,000	2,20,000	= 3,00,000		20,00,000
Jan. 20	(-)1,75,000	+5,75,000					+1,00,000	
Balance	8,90,000	5,75,000	5,75,000	4,40,000	2,20,000	= 3,00,000	4,00,000	20,00,000
Jan. 25	(-) 50,000	____	____	____	+50,000	____	____	
Balance	8,40,000	5,75,000	5,75,000	4,40,000	2,70,000	= 3,00,000	4,00,000	20,00,000
Jan. 30	+ 50,000	(-) 30,000			____			+ 20,000 (50,000 -30,000)
Balance	8,90,000	5,45,000	5,75,000	4,40,000	2,70,000	= 3,00,000	4,00,000	20,20,000

2.6 Journal

Journal is a book listing a Company's financial transactions other than cash, before adding them to ledgers. Currently, the journal is only used to a limited extent to cover topics outside the scope of other books of accounting. Let us understand the mechanism of recording business transaction in a journal.

A Journal, as originally used, is a book of primary entry in which transactions are copied in the order of date from a memorandum or waste book. The entries are then copied and classified into debts and credits, so far to facilitate their being correctly posted afterwards in the ledger". The proforma of a Journal is given here under:

Notes

Pro forma of a Journal

Date	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)

As per the above pro forma of Journal the first column is kept for date means date of transaction is recorded, second wide column for particulars of business transactions in which the related accounts are showed along with their narrations. Third column is for ledger folio number where the journal entry is posted in ledger. The fourth and fifth columns are kept for debit amount and credit amount.

Business transactions of Mr.A for the month of Jan.1997.

1st January, 1997	A started business with cash	Rs.20,000/-
3rd January, 1997	Goods purchased for cash	Rs.6,000/-
5th January, 1997	Goods purchased from S	Rs.4,000/-
7th January,1997	Goods sold for cash	Rs.2,000/-
10th January, 1997	Goods sold to B	Rs.6,000/-
12th January, 1997	Cash paid to S	Rs.2,000/-

Journal Entries

Date	Particulars Ledger Folio	Dr. Amount (₹)	Cr. Amount (₹)
1997 Jan. 1	Cash A/c Dr. to Capital A/c (Being cash introduced by A)	20.000/-	20.000-
jan. 3	Purchase A.c Dr. To Cash A/c (Being cash purchase)	4,000/-	6,000/-
Jan. 5	Purchase A/c Dr. To S'a A/c (Being credit purchase from S)	4,000	4,000/-
Jan. 7	Cash A/c dr. To sales A/c (Beingh cash sales)	2,000/-	2,000/-
Jan. 10	B's A/c Dr. To Sales A/c (Beingh the amount of credit sales)	6,000/-	6,000/-
Jan. 12	S.S A/c Dr. To Cash A/c (Being the amount of credit sales)	2,000/-	2.000/-

Notes

2.6.1 Functions of Journal

(i) ***Analytical Function***: The debit aspect and the credit aspect of each transaction are evaluated. It helps to determine how each transaction will affect the business financially.

(ii) ***Recording Function***: Accountancy is a business language that helps to record the transactions based on various principles. Each of the recording entry is supported by a narration that explains the transaction in a simple language. Narration means to narrate – i.e. to explain and it starts with the word – Being.

(iii) ***Historical Function***: It contains a chronological record of all the transactions for future references.

2.6.2 Advantages of a Journal

- ***Chronological Record***: It records transactions as and when it happens. Hence, it is possible to get detailed day to day information.
- ***Minimizing the possibility of errors***: The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into debit and credit aspect.
- ***Narration***: It refers to the explanation of the recorded transactions.
- ***Helps to finalize the accounts***: Journal is the basis of ledger posting and the ultimate Trial Balance.

2.7 Principal Book: Ledger

A ledger is a list of records. Most of us probably saw a bound book printed on the cover, with the word ' ledger. All an industry's accounts may be entered in a summarized and classified form in a ledger in the accounts concerned.

From the journal a trader cannot know his total cash, purchases, and the amount spent under each head of expense and also the amount earned under each head of the income. Further, the journal does not tell as to what the trader owes to his creditors and what his customers owe to him. Such classified information can be received only by opening ledger accounts for every kind of transaction.

Each ledger has two sides which are debit and credit. The left side is debit and the right side is credit. Each side of the ledger has columns on date, particulars, journal folio and amount. The name of the account from which benefit is earned is reported in the particulars column of the debit side, and on the credit side is recorded the name of the account to which benefit is received.

The book which contains accounts is known as the ledger. Since, finding information pertaining to the financial position of a business emerges only from the accounts, the ledger is also called the Principal Book. As a result, all the necessary information relating to any account is available from the ledger. This is the most important book of the business and hence is rightly called the "King of All Books". It is also known as the Book of Final Entry.

Notes

The specimen of a typical ledger account is given below:

(Dr.) Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)

(i) ***Ledger Posting:*** It is known as posting to transfer entries from the journal or a subordinate book to the ledger. Posting the journal ledger is simple as the journal transactions are already marked as debit and credit. The following points should, however, be noted before publishing the ledger.

- For the same person or expense only one account must be opened.
- Cash and credit sales should be posted to the sales account and cash and credit purchases to the purchase Account.
- The word Debit as Dr. and Credit as Cr. should not be omitted.
- Date and folio columns should not be left blank.

(ii) ***Balancing of Ledger Accounts:*** The debit and credit sides of individual ledger accounts are tallied at periodic intervals, and the balance of each account is shown. If any account's total debit side is more than the credit side, then there will be a debit balance, and if the credit side is more than the debit side, there will be credit balance.

Example:

Prepare Capital Account for the following transactions:

1. Rajesh commenced business with machinery ₹ 20,000 furniture ₹15,000 and cash ₹ 8,000
2. During the year he introduced ₹ 12,000

Dr. Capital Account Cr

Sl. No.	Particulars	JF	₹	Sl. No.	Particulars	JF	₹
				(i)	By Machinery A/c		20,000
				(i)	By Furniture A/c		15,000
				(i)	By Cash Amount		8,000
	to Balance c/d		55,000	(i)	By Cash Amount		12,000
			55,000				55,000

2.7.1 A Debit Denotes:

(a) In the case of a person has received some value from which he has already rendered some service or in the future will render service. When a person is responsible for doing something for the business, the fact is reported by debiting the account of that individual, this relates to Personal Account

Notes

(b) In case of goods or a property, the value and the stock of such goods or properties has increased, this relates to Real Accounts

(c) In case of other accounts like the losses or expenses, which the firm has incurred certain expenses or has lost money, this relates to a Nominal Account

2.7.2 A Credit Denotes:

(a) In the case of a person, he has earned some benefit, entitling him to claim a return profit from the firm in the form of cash or products or service. When for some reason a person is entitled to income or property. The fact is recorded by crediting him, this relates to a Personal Account.

(b) In the case of the goods or a property, that the stock and value of such goods or properties has decreased, this relates to the Real Accounts.

(c) In case of other accounts like the interest or a dividend or the commission received, or discount received, that the firm has made a gain, this relates to a Nominal Account.

Example –

Enter following transactions and post them in Leger –

January (2011) 2 Furniture purchased for Cash ₹ 20,000

January (2011) 5 Parmesha owed ₹ 1,500. He sent a cheque which was paid into bank the same day for INR 1,450 in full settlement.

January (2011) 9 Goods purchased for ₹ 16,000

January (2011) 15 Sold goods for ₹ 25,000

Journal Entries

Date	Particulars	L.F	Debit	Credit
Jan 2, 2011	Furniture Account Dr. To cash account (Being purchased furniture for cash)		20,000	 20,000
5	Bank Account Dr. Discount Account Dr. To Parmesha's account (Being amount received in full settlement from Parmesha)		1,450 50	 1,500
9	Purchases Account Dr. To Cash Account (Being purchased goods for cash)		16,000	 16,000
15	Cash Account Dr. To Sales Account (Being sold goods for cash)		25,000	 25,000
			62,500	**62,500**

Notes

Cash Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
2011 Jan 15	To Sales A/c		25,000	Jan. 2	By Furniture A/c		20,000
31	To Balance		11,000	9	By Purchases A/c		16,000
			36,000				36,000
				Feb. 1	By Balance b/d		11,000

Funiture Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
Jan. 2	To Cash A/c		20,000	Jan. 31	By Balance c/d		20,000
			20,000				20,000
Feb. 1	To Balance b/d		20,000				

Bank Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
Jan 5	To Parmesha's A/c		1,450	Jan. 31	By Balance c/d		1,450
			1,450				1,450
Feb. 1	To Balance b/d		1,450				

Discount Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
Jan 5	To Parmesha's A/c		50	Jan. 31	By Balance c/d		50
			50				50
Feb. 1	To Balance b/d		50				

Purchases Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
Jan 9	To Cash A/c		16,000	Jan. 31	By Balance c/d		16,000
			16,000				16,000
Feb. 1	To Balance b/d		16,000				

Notes

Sale Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount (Cr.)
Jan 31	To Balance c/d		25,000	Jan. 31	By Cash A/c		25,000
			25,000				25,000
				Feb. 1	To Balance b/d		25,000

2.7.3 Difference between Journal and Ledger

Basis	Journal	Ledger
Nature of book	It is the first/original book of entry	It is the book of final entry
Record	Book for chronological record	Book of analytical record
Weight in legal evidence	Book of source entry and has a greater weight as legal evidence	It has lesser weight as legal evidence is based on journal
Unit of classification of data	Unit of classification of data within the journal is transaction	Unit of classification of data within the ledger is an account
Process of recording	Process of recording in journal is called journaling	Process of recording in ledger is called posting
Place	More than one transaction regarding one account are written at places date wise.	More than one transaction regarding one account are written at one place.

2.8 Trial Balance

The trial balance is simply a list of names of the accounts, and the balances in each account at a given period of time, with debit balances in one column and credit balances in another column. The preparation of trial balance serves two principal purposes

- It shows whether the equality of debits and credits has been maintained and
- Provides a convenient transcription of the ledger record as a basis for making revisions and closing entries for final accounts preparations.

When the total debits equal total credits, it does not always represent that there has been no error in recording the transactions. Entries may have been omitted entirely, or they may have been posted to the wrong accounts, there can be off-setting errors that may have been made, or the transactions may have been analysed incorrectly.

For example when a debit for purchase of a tractor is made incorrectly to an expense account, rather than correctly to a fixed assets account, the total of the trial balance is not affected.

Nevertheless, errors that result in unequal debits and credits are common, and the existence of such errors is revealed when the trial balance does not balance. This is when the debit column does not add to the same total as the credit column. A trial

Notes

balance may be prepared at any time. A pre-adjustment trial balance is one prepared following the posting of the original entries for the year, but prior to the adjustment and closing process. Following the closing process a post closure trial balance is set.

2.8.2 Features of a Trial Balance

(i) It is a list of debit and credit balances which are extracted from various ledger accounts.

(ii) It is a statement of debit and credit balances.

(iii) The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.

(iv) It is usually prepared at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly.

(v) It is a link between books of accounts and the Profit and Loss Account and Balance sheet.

2.8.3 Preparation of Trial Balance

The following balance has been extracted from the books of ABC on March 2011, Draw out a trial balance.

Particulars	₹	Particulars	₹
Capital	11,60,000	Purchase	2,25,000
Cash balance	1,20,000	M/s DTTC	3,00,000
M/s CLTS (Cr.)	1,00,000	General expenses	75,000
Furniture	80,000	Land & Building	1,30,000
Goods	45,000	Return outwards	25,000
Drawings	75,000	Advertisement	60,000
Sundry debtors	1,45,000	Salaries	35,000
Commission received	3,000	Discount (Credit)	2,000

Trial Balance

Ledger Accounts	LF	Debit	Credit
Capital			11,60,000
Cash balance		1,20,000	
M/s GTLS (credit)			1,00,000
Furniture		80,000	
Goods		45,000	
Drawing		75,000	
Sundry debtors		1,45,000	
Salaries		35,000	

Notes

Commission received			3,000
Discount (Credit)			2,000
Purchase		2,25,000	
M/s DTTC (Dr)		3,00,000	
General expenses		75,000	
Land & Building		1,30,000	
Return outwards			25,000
Advertisement		60,000	
		12,90,000	12,90,000

2.8.4 Purpose of a Trial Balance

It serves the following purposes:

1. To check the arithmetical accuracy of the recorded transactions.
2. To ascertaining the balance of any of the ledger accounts.
3. To serve as an evidence of fact that the double entry has been completed in respect of every transaction.
4. To facilitate the preparation of final accounts promptly

Example –

From the following ledger account balances, prepare a Trial Balance of Mr. Tom for the year ended 31st March, 2016.

Capital ₹80,000; Sales ₹10,00,000; Adjusted Purchase ₹8,00,000; Current A/c(cr) ₹10,000; Petty Cash ₹10,000; Sales Ledger Balance ₹1,20,000; Purchase Ledger Balance ₹60,000; Salaries ₹24,000; Carriage Inwards ₹4,000; Carriage Outward ₹6,000; Discount Allowed ₹10,000; Building ₹80,000; Outstanding Expenses ₹10,000; Prepaid Insurance ₹2,000; Depreciation ₹4,000; Cash at Bank ₹80,000; Loan A/c (cr) ₹66,000; Profit & Loss A/c(cr) ₹20,000; Bad Debts Recovered ₹2,000; Stock at 31.03.2016 ₹1,20,000; Interest Received ₹ 0,000; Accrued Interest ₹4,000; Investment ₹20,000; Provision for Bad Debts (01.04.2015) ₹ 6,000; General Reserve ₹20,000.

Solution –

Head of Accounts	Amount	Head of Account	Amount
Adjusted Purchase	8,00,000	Capital	80,000
Petty Cash	10,000	Sales	10,00,000
Sales Ledger Balance	1,20,000	Current A/c	10,000
Salaries	24,000	Purchase Ledger Balance	60,000
Carriage Inward	4,000	Outstanding Expenses	10,000
Discount Allowed	10,000	Loan A/c	66,000
Building	80,000	Profit & Loss A/c	20,000

Notes

Prepaid Insurance	2,000	Bad Debts Recovered	2,000
Depreciation	4,000	Interest Received	10,000
Cash at Bank	80,000	Provision for Bad Debts	6,000
Stock (31.03.2016)	1,20,000	General Reserve	20,000
Accrued Interest	4,000		
Investment	20,000		
Carriage Outward	6,000		
Total	12,84,000	Total	12,84,000

Note: Closing Stock will appear in Trial Balance since there is adjusted purchase. Adjusted purchase = Opening Stock + Purchase - Closing Stock.

2.8.5 Limitations of a Trial Balance

A trial balance is not a conclusive proof of the books of accounts being absolutely accurate. If the trial balance agrees, this doesn't mean that books now have absolutely no mistakes. Even if the trial balance agrees, certain errors will remain undetected, and the trial balance will not disclose them. The errors which are not disclosed by a trial balance are as under:

(i) ***Errors of Omission***: - If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.

(ii) ***Errors of Commission***: This refers to the posting an item on the correct side but to the wrong account

(iii) ***Error of subsidiary books***: This refers to the wrong amount being entered in the subsidiary book.

(iv) ***Compensating errors***: These are errors arising from the excess-debits on under debits of accounts being neutralized by excess credit or under credit to the same extent of some other accounts.

(v) ***Error of principle***: Whenever any amount is not properly allocated between capital and revenue or some double entry principles are violated the error so made is known as error of principle.

(vi) ***Compensatory Errors***: These are the errors on one side of the ledger account, and are compensated by errors of the same amounts on the other side or on the same side

2.8.6 Suspense Account

When the Trial Balance does not tally, efforts are made to make the trail balance tally. However, if the efforts fail, then temporarily the difference of Trail Balance is transferred to an account known as the "Suspense Account". Suspense Account is shown in the balance sheet on asset aside in case of a debit balance and on the liabilities side in case of a credit balance. During the course of preparation of final accounts if errors are located, they are corrected through the suspense A/c.

Notes

Effect on Profit and Losses

Account All such rectifying entries which are related to normal account, affect profit or loss, hence after making rectifications, all nominal account which are affected should be taken into consideration and their amounts be considered for assessing the exact amount of loss or profit.

Effect on Balance Sheet

All such rectifying entries which are related with personal and real accounts affect the Balance Sheet. Rectifying entries related with nominal account affect profit or loss and this profit or loss is taken to Balance Sheet. Hence, these entries also affect Balance Sheet

2.9 Voucher

Each transaction is recorded in account books which provide all the transaction information needed. Since each transaction has an impact on the financial position of the Company, a documentary evidence should be given to establish the monetary accounts in which transactions are reported and also properly authorized.

The common documents that are generally used are as under:

(i) ***Payment voucher*** - A Payment voucher usually on a printed standard form, is a record of payment. When payment is made for an expense, generally a bill is prepared to record full particulars of the claim by the person or organisation receiving payment. From the bill, the accounting department prepares a voucher for each payment to be made, no matter whether the amount that is paid for the goods purchased, or to pay employee's salaries, or to pay for services or to pay for any other asset acquisition.

(ii) ***Receipt voucher*** - A Receipt voucher is a document which is issued against cash receipts. It may also be a printed standard form. This document shows that a certain sum of money was received from a person or organisation and also, contains information of the purpose for which the money is received. It is signed by a responsible employee, authorised by the management to receive the money.

(iii) ***Transfer voucher*** - A transfer voucher is used to record the residuary transactions. An internal transaction or a transaction which does not involve any cash payment or cash receipt, is recorded in the transfer voucher. Examples include, the goods purchased on credit, depreciation of assets, accrued income, outstanding expenses etc.

2.10 Accrual and Cash Basis of Accounting

(I) ***Accrual Basis of Accounting*** - Accrual Basis of Accounting is a method to record transactions by which revenue, costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes the consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting.

Notes

(II) ***Cash Basis of Accounting*** - Cash Basis of Accounting is a method to record transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

Difference between Accrual and Cash Basis of Accounting

Basis	Accrual Basis of Accounting	Cash Basis of Accounting
Prepaid/Outstanding Expenses / accrued/ unaccrued Income in Balance Sheet.	Under this, there may be prepaid/ outstanding expenses and accrued/ unaccrued incomes in the Balance Sheet	Under this, there is no prepaid / outstanding expenses or accrued / unaccrued incomes.
Higher/lower income in case of outstanding expenses and unaccrued income	Income Statement will show a relatively lower income.	Income Statement will show higher income.
Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/ WDV	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

3. Subsidiary Books

All business transactions, at the first stage, are recorded in the book of original entry, which is the Journal and then is posted into the ledger under the double entry system of book-keeping. This procedure is both easy and practicable in small business houses where the numbers of business transactions are less and where a single person can also handle the business transactions.

But it is practically very difficult, rather impossible, to record all the business transactions of a day in the Journal of a large business house where the number of business transactions are varied and enormous because of the following reasons:

(i) The system of recording all transactions in a journal requires -

- Writing down the name of the account involved as many times as the transactions occur; and
- An individual posting of each account debited and credited and thus, involves the repetitive journalising.

(ii) The information is not provided on a prompt basis.

(iii) The journal becomes bulky and voluminous.

(iv) The system does not facilitate the installation of an internal check system, as the journal can be handled by only one person.

Notes

Therefore, to overcome the shortcomings of the use of the journal as the only book of original entry, the journal is subdivided into special journals. It is divided in such a way that a separate book is used for each category of business transactions which are repetitive in nature, similar and are sufficiently large in number. Special journals refer to the journals meant for recording specific business transactions of similar nature.

- **Cash Book**: It records all those transactions which are in cash or by cheques.
- **Purchases Book**: It records all transactions relating to goods purchased on credit.
- **Sales Book**: It records all transactions relating to goods sold on credit.
- **Purchases Return Book**: It records return of goods to suppliers.
- **Sales Return Book**: It records return of goods by the customers.
- **Bills Receivable Book**: It records entries regarding bills receivables. The details of bills are given in this book.
- **Bills Payable Book**: All bills which are accepted and payable by a business house are recorded in this book.
- **Journal Proper**: Those transactions which are not recorded in any of the above mentioned books are recorded in the Journal Proper.

3.1 Advantages of using Special Journals

- ***Facilitates division of work***: The accounting work can be divided among many persons. Thus, the work is completed quickly and with efficiency.
- ***Time and labour saving in journalising and posting***: For instance, when a Sales Book is kept, the name of the Sales Account is not be required to be written down in the Journal as many times as the sales transactions occurs. At the same time, Sales Account will not be required to be posted again and again since, only a periodic total of Sales Book is posted to the Sales Account.
- ***Permits the use of specialised skill***: The accounting work requiring specialised skill may be assigned to the person possessing the required skill. With the use of a specialised skill, quick, economical and more accurate supply of accounting information may be obtained.
- ***Permits the installation of internal check system***: The accounting work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of error or fraud can be avoided

3.2 Cash Book

A Cash Book is a special journal, used to record all cash receipts and cash payments. There is no need to prepare a cash account in the ledger if a cash book is maintained. However, all other aspects of transactions are recorded in the ledger.

Cash Book serves a dual role of journal as well as a ledger. Cash Book is the book of original entry (Journal) since transactions are recorded for the first time from the source documents. It is a ledger in the sense that it is designed in the form of

Notes

Cash Account and records cash receipts on the debit side and cash payments on the credit side.

3.2.1 Features of Cash Book

- Only cash transactions are recorded in the Cash Book.
- It performs the functions of both journal and the ledger at the same time.
- All cash receipts are recorded on the debit side and all the cash payments are recorded on the credit side.
- In a Cash Book, recording of only cash transactions can never show a credit balance.

3.2.2 Kinds of Cash Book

Cash Book can be of several kinds -

(a) Single Column Cash Book - For recording only the cash transactions.

(b) Double (Two) Column Cash Book- For recording the cash transactions involving gain or loss on account of discount.

(c) Triple (Three) Column Cash Book- For recording the cash and bank transactions involving gain or loss on account of discount.

(d) Petty Cash Book- For recording only the petty expenses.

a. Single Column Cash Book

Single Column Cash Book has one column of amount on each side. All cash receipts are recorded on the debit (left-hand) side and all cash payments are recorded on credit (right-hand) side. It is nothing but a Cash Account, thus there is no need to open Cash Account in the ledger. Posting from the debit (receipt) side of the Cash Book is done to the credit side of concerned accounts and from the credit (payment) side of the Cash Book to the debit side of the concerned accounts.

The format of a single cash book is -

Dr. Cr.

Date	Particulars (Receipts)	LF	Amount (₹)	Date	Particulars (Payments)	LF	Amount (₹)

Balancing the Cash Book

Cash Book is balanced in the same manner as a ledger account. To verify the accuracy of the entries made and to confirm the authenticity of cash balance, it should be balanced daily. The balance as per Cash Book must tally with the actual cash in hand. In the Cash Book, the total of amount column of the debit side always exceeds the total of credit side. As such, the Cash Book always shows a debit balance, since

Notes

we cannot pay more than we have with us. At the end of the period, the balance of the Cash Book is placed on the credit side by writing "By Balance c/d" and then the totals are shown on both sides in one straight line. Total of each side should be same.

Illustration 1. Enter the following transactions in the Cash Book of Mr. Nikhil

2006		₹
March 1	Mr. Nikhil commenced business with Cash	6,500
March 3	Bought goods for cash	685
March 4	Paid to Mohan	95
March 6	Deposited in the bank	4,000
March 6	Purchased office furniture on cash	465
March 9	Sold goods for cash	3,000
March 12	Paid wages in cash	120
March 13	Paid for stationary	40
March 15	Sold goods for cash	2,500
March 17	Paid for miscellaneous expenses	45
March 19	Received cash from Tarlok	485
March 21	Withdrew for domestic use	250
March 22	Paid salary	400
March 25	Paid rent	90
March 28	Paid electricity bill	35
March 29	Paid for advertising	40
March 31	Paid into bank	2,500

Solution

Cash Book

Dr. Cr.

Date	Particulars (Receipts)	LF	Amount (₹)	Date	Particulars (Payments)	LF	Amount (₹)
2006				2006			
March 1	To Capital A/c		6,500	March 3	By Purchases A.c		685
March 9	To Sales A/c		3,000	March 4	By Mohan's A/c		95
March 15	to Sales A/c		2,500	March 6	By Bank A/c		4,000
March 19	To Tarlok's A/s		485	March 6	By Furniture A/c		465
				March 12	By Wages A/c		120
				March 13	by Stationery A/c		40
				March 17	By Misc. Expenses A/c		45
				March 21	By Drawings A/c		250
				March 22	By Salaries A/c		250

				March 25	by Rent A/c		400
				March 28	By Electricity A/c		35
				March 29	By Advertisement A/c		40
				March 31	By Bank A/c		2,500
				March 31	By Balance C/d		3,720
			12,485				12,485

b. Double Column Cash Book

Double column Cash Book has two amount columns one for cash and another for discount on each side. In industry, it is customary to require discount when a customer receives the payment promptly and before the due date. It is similarly so when payment to a creditor is made prior to due date. All cash receipts and discount allowed are recorded on the debit side, and all cash payments and discounts received are recorded on Cash Book's credit side. The cash column posting is done in the same way as in a Single Column Cash Book.

Entries from the debit side of the cash book's discount column are listed on the credit side of each individual debtor's account to which the business has allowed the discount. The total of the debit side of the discount column is shown on the debit side of the "Discount Allowed Account" by writing "To Sundries" in particulars column. Entries from the discount column of the credit side are posted on the debit side of every individual creditor's account by which the discount is allowed to the business. The total of the credit side of the discount column is shown on the credit side of the "Discount Received Account" by writing "By Sundries" in the particulars column.

The Double Column Cash Book cash column is balanced in exactly the same way as for the Single Column Cash Book. Nevertheless, the columns of discounts are not balanced but merely totaled. Both totals are added to the Discount Allowed Account and Discount Provided Account respectively.

The format of double column cash book is:

Dr. Cr.

Date	Receipts	LF	Discount (₹)	Cash	Date	Payments	LF	Discount (₹)

c. Triple Column Cash Book

Triple column Cash Book is an improvement over the Double Column Cash Book. In modern times, it is virtually impossible to imagine any business without having bank dealings. The transactions relating to receipts and payments of money are majorly made through cheques. Thus, the transactions through banks are also recorded in the cash book by adding one more column i.e. bank column on both sides of the cash book. Therefore there are three columns on both sides of the cash book. These columns are

Notes

cash, bank and discount columns. Thus, this type of cash book is known as the Triple Column Cash Book.

Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)

Receipt side (Dr side) – This side of the Triple Column Cash Book is used to record all the receipts both in cash and by cheque. The discount allowed to our debtors while receiving the payment is also recorded. Cash receipts are entered in the cash column whereas amounts received by cheques are entered in the bank column and discount allowed in the discount column. Posting from the debit side of the cash book is added to credit side of each account in the ledger, however in the case of personal accounts credit is to be given for cash or cheques received plus discount allowed.

Payment side (Cr. side) - This side of the Cash Book is used to record all payments both in cash and through cheques as also to record the discount received or availed by over creditors while making payment to them. Cash payments are recorded in the cash column, payments through cheques are entered in the bank column and discount received in the discount column. Posting from credit side of the cash book is added on debit side of respective accounts, however in the case of personal accounts debit is to be given for the total of the payments made and discount received. After recording all the relevant transactions in the Cash Book, all the columns of the Cash Book are totaled.

Example:

From the following particulars, write up the Cash Book of M/s K.K. of Chennai with Cash and Bank columns and bring down the final balance.

2009		(₹)
Oct. 1	Csh in hand	100
Oct. 1	Cash in bank	3,500
Oct. 5	Paid salary by cheque	250
Oct. 7	Paid to K.K. & Co. by cheque	260
Oct. 9	Received a cheque from B & Co.	2,500
Oct. 12	Bought goods from cash paid by cheque	250
Oct. 15	Received cash from M/x S. Chand	1,500
Oct. 17	Depositted cash into bank	1,4,50
Oct. 18	Sundry creditors were paid by cheque	1,250
Oct. 19	Received from debtors by cheque which could not be sent to bank	1,780
Oct. 20	B & Co. cheque dishonoured	2,500

Notes

Oct. 20	B & Co. cheque dishonoured	2,500
Oct. 22	B & Co. paid cash	2.500
Oct. 24	R & Co. issued a cheque for ₹ 470 in full satisfaction of his account for	500
Oct. 27	Shyam Lal was paid ₹ 395 in full settlement of his A/c amounting to	400
Oct. 31	Deposited into the Bank	2,200

Solution:

Dr. Cr.

Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)
2009						2009					
Oct. 1	To Balance b/d.			100	3,500	Oct. 5	By Salaries A/c			-	250
Oct. 9	To B & Co.			-	2,500	Oct. 7	By K & Co.			-	260
Oct. 15	To S. Chand			1,500	-	Oct. 12	By Purchase A/c			-	750
Oct. 17	To Cash A/c	(c)		-	1450	Oct. 17	By Bank A/c	(c)		1450	-
Oct. 19	To Debtors			1780	-	Oct. 18	By S. Creditors			-	1250
	A/c			2,500	-	Oct. 20	By B & Co			-	2,500
Oct. 22	To B & Co.		30		470	Oct. 27	By Shyam Lal		5	395	
Oct. 24	To R & Co.	(c)			2,200	Oct. 31	By Bank A/c	(c)		2,200	
Oct. 31	To Cash A/c						By Balance c/d			4,885	5,110
			30	10,120					5	5,880	10,120

- The difference in the cash columns is put on the credit side of Cash Book in the column by writing "By Balance c/d". The bank balance may have a debit balance or a credit balance.

Notes

- If the total of the debit side of the bank column is more than the total of the credit side of the bank column, it has a debit balance and if the total of the credit side is more than that of the debit side, then it has a credit balance (overdraft).
- However, the difference is put on the lesser side. There is no need to balance the discount columns. The discount columns of both the sides are totaled. In the Triple Column Cash Book there will be some cross or contra entries i.e., transfer of money from cash to bank (amount deposited) and vice-versa (amount withdrawn from bank for office use).
- In all such cases both entries occur in the cash book and no ledger entry is required. This is indicated by a contra sign (C) in the folio column indicating thereby that the double entry aspect of this transaction is complete and it requires no posting to the ledger.

3.3 Petty Cash Book

In every business, there are a number of payments involving small amounts such as the payments for postage, telegrams, cartage etc. If all these transactions are recorded in the Cash Book, it will increase the head cashier's work manifold and will unnecessarily make the Cash Book bulky and uneasy.

Normally, an individual is handed over a small amount to meet the petty expenses of a given period like a week, a fortnight or a month and is authorised to make such payments and to record them in a separate Cash Book. Such an individual is known as the Petty Cashier, the amount is the 'Imprest' and the cash book is the 'Petty Cash Book' respectively.

The Petty Cash Book may or may not be maintained on an 'Imprest System'. Under both the systems (i.e. Imprest and Non-imprest), the petty cashier submits the Petty Cash Book to the Head Cashier who then examines the Petty Cash Book. Under the Imprest system, the Head Cashier makes the reimbursement of the amount spent by the Petty Cashier but under Non-imprest system, the Head Cashier may handover the Cash to the Petty Cashier equal for the amount spent.

Usually, the Petty Cash Book is maintained on the basis of imprest system.

The Performa of the petty cash book is:

Receipts (₹)	Date	Particulars	Voucher No.	Total Amount (₹)	Printing & Stationery	Cartage	Postage	Remarks

Notes

Example:

Enter the following transactions in Analytical Petty Cash Book.

2009		(₹)
Jan. 1	Received cheque from head cashier	100.00
Jan. 2	Paid to postage and belegram	15.00
Jan. 3	Stationery perchased	5.00
Jan. 14	Paid for cartage	8.00
Jan. 18	Paid for travelling	7.00
Jan. 27	Free for guests	6.00
Jan. 29	Office clearing chrges	12.00
Jan. 30	Paid for carriage	4.00
Jan. 31	Telegram charges	8.00

Solution:

Receipts (₹)	Date	Particulars	Voucher No.	Total Amount (₹)	Postage telegram	Stationery	Cartage Travelling	Tea & office expenses	Remarks
	2009								
100.00	Jan. 1	To cash a/c		-					
	Jan. 2	By Postage & telegram		15.00	15.00	-	-	-	
	Jan. 3	By Stationery		500	-	500	-	-	
	Jan. 14	By Cartage		8.00	-	-	8.00	-	
	Jan. 18	By Travelling		7.00	-	-	7.00	6.00	
	Jan. 27	By Tea for guest		6.00	-	-	-	12.00	
	Jan. 29	By office clearing charges		12.00	-	-	-	-	
	Jan. 30	By Cartage		4.00		-	-	-	
	Jan. 31	By Telegram		8.00	8.00	-	4.00		
		By Balance c/d		35.00	23.00	5.00	19.00	18.00	
		Total		100.00					
35.00	Feb. 1	By Balance b/d							
65.00		To Cash							

Notes

3.3.1 Advantages of Imprest System:

(i) The money in the hands of the petty cashier is limited to the imprest amount.

(ii) As periodical reimbursements are the actual expenses paid and not mere advances on account only, they are brought prominently to the notice of Chief Cashier.

(iii) The Chief Cashier, by handing over a fixed sum, is relieved of the cumbersome work of the petty disbursements.

(iv) The main cash book is not unnecessarily clogged with the large number of small items. Even in the ledger, only the totals are posted.

(v) At all time, the amount of cash in hand plus expenses not reimbursed must equal the imprest amount, thus, facilitating a simple check.

(vi) The maximum liability of the petty cashier can never exceed the imprest amount.

3.4 Purchase Book

Purchases Book also known as the Invoice Journal or the Bought Journal or Purchases Journal is used to record only the credit purchases of goods and merchandise in which the business is dealing, i.e. goods purchased for resale purpose for earning revenue. It records neither the cash purchases of goods nor the purchase of any asset other than the goods or the merchandise.

- When the goods are purchased on credit a statement is received from the supplier regarding the particulars of the goods supplied by him. This statement is called an Invoice. The invoice states the price, quality and the value of goods supplied. It also states the discount allowable (both trade and cash) and the conditions under which payment is expected.
- The entries in the purchase book are made on the basis of invoices received from the supplies with the amounts net of trade discount or the quantity discount. Trade discount is the supplier's reduction from the selling price of goods and services on market criteria such as purchased volume, trade activities other than prompt payment.
- The purpose of allowing trade discount is to encourage the seller to sell the goods at the list price to the consumer and still have the margin to meet business expenses and profit. Entries in the supplier's and the retailer's books are based on the net amount i.e. invoice price less trade discount.

  Posting after recording transactions in the Purchases Book, the posting in ledger accounts will be made. The posting from the Purchases Book is made as follows:

a) Debit the Purchases Account with the periodical totals of the Purchases Book. On the debit side of the Purchases Account, write "To total as per Purchase Book" or "To Sundries" in the particulars column.

b) Personal accounts of each individual supplier is credited with the net amount of Inward Invoice recorded in Purchases Book by writing "By Purchases".

Following the format for purchase book:

Notes

Purchases Day Book

Date	Particulars	Invoice No.	L.F.	Details (₹)	Amount (₹)
I	II	III	IV	V	VI

(a) Column is meant for date.

(b) Column is meant for writing details regarding name of supplier, name of articles purchased and number i.e., quantities.

(c) Invoice No.: An Invoice is given to the seller when purchases are made on credit

(d) Ledger Folio

(e) Amount of the purchase

Thus, all the credit purchases are totalled which give us the amount of total credit purchases made during the period

Example:

Following information is obtained from the books of Mr. Joseph.

2011		(₹)
July 1	Purchased goods from Robert on credit	4000
July 2	Purchased office furniture from Delite Purniture on credit	5000
July 3	Purchased on credit goods from Robinson	3000
July 4	Purchased stationery on credit from Bittoo	500
July 5	Purchased goods for cash	7,500

You are required to make out a purchases day book of Mr. Joseph.

Solution:

Date	Particulars	Invoice No. 1	L.F.	Amount (₹)
2011				
July 1	Robert			4000
July 3	Robinson			3000
	Total			7,000

3.5 Sales Book

Sales Book or the Sales Journal is written to record all the credit sales. Sales Book records only those goods that are sold on credit and the goods in question must be those that the firm generally deals in. If there are cash sales they are recorded in Cash Book, whereas the sales of assets are recorded in the Journal proper.

The entries in the Sales Book are made from copies of the invoices that have been sent to customers along with the goods. Such copies of the invoices may be termed as Outward Invoice. Each outward invoice must be numbered consecutively and the

Notes

reference should be given in the Sales Book along with the entry.

The Sales book is totaled periodically. The net amount of the invoices in Sales Book is posted to the ledger as follows:

(a) Debit the personal accounts of the customers with the value of sales to them.

(b) Credit Sales Account with the periodical total

Following is the format of sales book -

Date	Particulars	Invoice No.	L.F.	Details (₹)	Amount (₹)
I	II	III	IV	V	VI
	Details fo goods-sold-trade discount if any total				

Thus, all the credit sales are totalled which give us the amount of total credit sales made during the period.

3.6 Purchase Return Book

In every business, it is not uncommon to find that the goods are returned by a business Company to the suppliers because of various reasons, like the goods being defective, or goods not according to order. If the returns are frequent in a business, then a separate book may be maintained to record such transactions which are known as Purchases Returns Book or the Returns Outward Book.

The entries in the Purchases Returns Book are generally made on the basis of debit notes issued to the suppliers. When a business returns any products to it vendors, a debit note is prepared in duplicate. The original copy is sent to the supplier to whom the goods are returned. The Debit Note is so named because the account of the manufacturer is debited with the balance of the returned goods.

After recording the transaction in Purchases Returns Book, posting to the ledger involves –

(a) The periodical total of the Purchases Return Book is posted to the credit of the Purchases Return Account in the ledger.

(b) The personal account of each individual supplier is debited with the amount of Debit Note.

Following is the format of purchase return book

Date	Particulars	Invoice No.	L.F.	Details (₹)	Amount (₹)
I	II	III	IV	V	VI

3.7 Sales Return Book

Sales Return Book or the Returns Inwards Book records the return of goods sold on credit. The goods that are sold for cash if returned are either exchanged for new goods or the parties are paid in cash. The columns used in the book are similar to the

Notes

Sales Book except that in place of Invoice Number, the Credit Note number is recorded.

Credit Note is just the reverse of a Debit Note and the seller sends it to the buyer. The note is an acknowledgment of goods returned as well as information to the debtor that his account is being credited with the amount mentioned in it. Thus, the party to whom a Credit Note is sent becomes a creditor.

The posting from the Sales Return Book is done periodically on the debit side of the Sales Returns Account in the ledger and the individual accounts of the customers are credited with their respective amounts.

The form of sales Returns Book is as follows:

Date	Particulars	Invoice No.	L.F.	Details (₹)	Amount (₹)
I	II	III	IV	V	VI

Example:

Enter the following transactions in the Sales Returns Book

July 01 Ramesh returned goods 6500

July 10 Allowance claimed by Murthy 9,500 accepted

July 15 Suresh returned us goods worth 2000

July 20 Received a Debit note from Narayan for 600

July 25 Received goods returned by Chandra 500

July 30 Allowance granted to Mohan for breakage 500

July 30 Received goods returned by Arvind and paid 1,600 in full settlement.

Solution:

Sales Return Book

Date	Particulars	Invoice No. 1	L.F.	Amount (₹)
2011				
July 1	Ramesh			6,500
July 10	Murthy			9,500
July 15	Suresh			7,000
July 25	Chandra			500
July 30	Mohan			500

- Transaction of July 20, receiving a debit note is not a transaction. Sales Returns book is written on the basis of Credit note.
- Transaction of July 30, it is a cash transaction. It is not to be entered in sales returns book.

Notes

3.8 Bills Receivable Book

Where a payment for a business transaction is not made immediately but is delayed or postponed for a few months, the creditor (seller) on his debtor (purchaser) may draw a bill of exchange payable some time in advance. The bill of exchange is then accepted by the debtor indicating that, there will be a payment of the specified amount, therein on the expiry of the period stated on the bill.

To the creditor, drawing the bill upon his customer, it is termed as Bills Receivable, which represents the money to be received at a future date; whereas to the debtor, the bill on acceptance becomes a Bills Payable indicating that the money needs to be paid at a future date.

Transactions involving drawing, acceptance and a negotiation of bills are recorded in Bills Receivable and Bills Payable Books respectively. Bills Receivable Book records the details of bills receivable on which the business Company will receive the amounts from other parties in future. The entries in this book include the name of the acceptor (debtor), the terms, due date, the amount and others.

Posting: The sum of the Bills Receivable Book amount column is debited to the Bills Receivable Account while the amount of each receivable bill is added to the credit of the account of the party from which it is issued.

The format of bills receivable book is-

Date of Receipt	From Whome received	Drawer	Acceptor	Endorser (s)	Date of Bill	Tenor or Terms of Bill	Due date	Where Payable	L.F.	Cash Discount Allowed	Ammount of bill (₹)	Remarks

3.9 Bills Payable Book

This is also an original entry book and is used to record the particulars of all bills payable approved by the business for the purpose of paying sums owed by the Company to its or its creditors at a future date. The entries that are to be made in this book relate to the drawer's name, the payee's name, the time, the due date and other information. Then the acceptance is duly returned to the drawer.

Posting: The amount of each bill is posted in the ledger to the debit side of the drawer's account, and the sum of the Bills Payable Book's amount column is posted to the Bills Payable Account credit in the ledger.

The format of bills payable book is-

Notes

Date	To Whom Payable	Term	Drawer	Acceptor	Endorser (s)	Due Date	Where Payable	L.F.	Amount (₹)	Remarks

3.10 Journal Proper

Journal Proper is a residuary book in which such transactions are recorded, that cannot be recorded in any other subsidiary book such as

(a) Cash Book,

(b) Purchases Book,

(c) Sales Book,

(d) Purchases Returns Book,

(e) Sales Returns Book,

(f) Bills Receivable Book, and

(g) Bills Payable Book.

The various examples of transactions entered in a Journal Proper are:

(i) ***Opening entry***: An Opening Entry is passed in the journal to record in the books of the current accounting period the amount of various assets, liabilities and resources that exist in the Balance Sheet of the previous accounting period.

(ii) ***Closing entries***: Closing Entries are passed in the journal for closing the nominal accounts by transferring them to the Trading and Profit and Loss Account. These are needed at the end of the accounting year, when the final accounts are prepared.

(iii) ***Transfer entries***: Transfer Entries are passed in the journal for transferring the amount from one account to another account, i.e. the transfer of total drawings from Drawings Account to Capital Account.

(iv) ***Adjusting entries***: Adjusting Entries are passed through the journal to bring certain unrecorded items, such as closing stock, depreciation on fixed assets, outstanding and prepaid items, into account books. These are required when final accounts are being prepared.

(v) ***Rectifying entries***: Rectifying Entries are passed in the journal to rectify the various errors committed while posting, totaling, balancing etc.

(vi) ***Miscellaneous entries***: This include the following:

(a) **Capital brought in kind** - If the business owner carries in its capital investment in kind and not in cash, such expenditure can only be reported in the Journal Proper and not in the Cash Book as it does not require any cash inflow.

Notes

(b) **Purchase of Assets** - Other than Stock-in-trade on credit that is the land, building, plant and machinery, furniture and fixtures. Such transactions can neither be recorded in the Purchase Book, as no goods have been purchased nor recorded in the Cash Book, as the transactions do not involve any cash outflow.

(c) **Sales of Assets**- Other than Stock-in-trade which was sold on cre0dit. Such transaction can neither be recorded in the Sales Book, as no goods have been sold nor can be recorded in the Cash Book as the transaction does not involve any cash inflow.

(d) **Return of Assets** - Other than Stock-in-trade which were sold on credit. Such transactions cannot be recorded in the Return Inwards Book since no goods have been returned.

(e) **Endorsement of Bills** Receivable to a creditor and the dishonour of Bills Receivables (not discounted with bank).

(f) Cancellation of Bills Payable.

(g) Abnormal Loss of Stock-in-trade or other assets by theft, accident, fire, etc.

(h) Writing-off Bad Debts.

Key Takeaways

- ***Accounting***: Accounting is treated as the language of business. It records all the transactions which can be measured in money and have occurred in a particular period.
- ***Cost accounting:*** It is intended to capture an Enterprise's production costs by assessing the input costs for each production phase, as well as fixed costs such as depreciation of an equipment
- ***Management accounting:*** It is the application of professional knowledge and skills for the preparation and presentation of accounting information
- ***Account***: An account is a record used to properly classify the activity recorded in the General Ledger.
- ***Accrual Basis*** - Method of accounting that recognizes revenue when earned, rather than when collected and expenses when incurred rather than when paid. The college uses the accrual basis for its accounting.
- ***Asset***- Anything of use to future operations of business and belonging of an enterprise. An asset is what the college owns. For example- land, property, buildings, equipment, cash in bank accounts, other investments and accounts receivable.
- ***Credit*** - A credit is an entry on the right side of a double-entry accounting system that represents the reduction of an asset or expense or the addition to a liability or revenue.
- ***Debit*** - A debit is an entry on the left side of a double-entry accounting system that represents the addition of an asset or expense or the reduction to a liability or revenue.

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- ***Double-Entry Accounting*** - Method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting.
- ***Expense/Costs*** - It is the expenditure incurred by enterprise to earn revenue. An expense is funds paid by the college. For example-paychecks to employees, reimbursements to employees, payments to vendors for goods or services.
- ***Equity***- It refers to total claims against enterprise. It is further dividers into Owner's Claim (Capital) and Outside's Claim (Liability).
- ***GAAP*** - GAAP stands for Generally Accepted Accounting Principles which are conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.
- ***General Ledger*** - The general ledger is the collection of all asset, liability, fund balance (net assets), revenue and expense accounts.
- ***Journal Entry*** - A journal entry is a group of debit and credit transactions that are posted to the general ledger. All journal entries must net to zero so debits must equal credits.
- ***Liability*** - A liability is what the college owes. For example-loans, taxes, payables, long term debt from a bond issue, funds held by the college for a third party such as a student group.
- ***Subsidiary Ledger*** - A subsidiary ledger is a group of accounts containing the detail of debit and credit entries. For example detail information contained in Accounts Payable.
- ***Revenue*** - Revenue is funds collected by the college; it can also be called income. It is monetary value of products/services sold to customers during the period. For example-tuition, fees, rentals, income from investment.
- ***Cash Book***- Cash book was used to record all cash and bank related transactions. Some records only the cash related transactions while other use the cash book for both type of transactions.
- ***General Ledger*** - The General Ledger contains all the accounts of an enterprise.
- ***Trial Balance***- In accounts every amount that is placed on the debit side of an account must have a corresponding entry on the credit side of some other account.
- ***Profit and Loss Account***- The account is prepared to see the profit earned or loss incurred by an enterprise within specific period. The account is usually made on a yearly basis.
- ***Balance Sheet***- The Balance Sheet is a statement summarizing the financial position of a business on a given date. It summaries on the right hand side the assets of the business and on the left hand side the liabilities of the business.

Check your progress

1. Sales return book is also known as -

   a) Cash book

Notes

b) Returns Inwards Book

c) Ledger

d) Bills payable book

2. There are ______________ types of Voucher

a) 2

b) 3

c) 5

d) 7

3. If the efforts fail, then temporarily the difference of Trail Balance is transferred to an account known as the

a) Cash Book

b) Suspense Account

c) Depreciation Account

d) Subsidiary Account

4. ___________ lists a company's financial transactions other than cash.

a) Journal

b) Returns Inwards Book

c) Ledger

d) Bills payable book

5. __________________ an original entry book and is used to record the particulars of all bills payable approved by the business.

a) Cash book

b) Cost Sheet

c) Ledger

d) Bills payable book

Questions & Exercises

1. Define Accounting. How is that different from Accountancy and Book-keeping?
2. Explain various steps in the process of Accounting.
3. Differentiate between accrual and cash basis of accounting.
4. What is a Trial balance?
5. What is a Journal Proper?

Check your progress:

1. b) Returns Inwards Book
2. b) 3
3. b) Suspense Account
4. a) Journal
5. d) Bills payble book

Notes

Further Readings

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3. *Introduction to Accountancy*. T S Grewal. S Chamd & Co Ltd
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6. *Advanced Accounts*. Shukla M.C., Grewal T.S.: S. Chand & Company Ltd., New Delhi.
7. *Advanced Accountancy.* Gupta R.L., M. Radhaswamy: Sultan Chand & Sons, New Delhi.
8. *Financial Accounting*. Tulsian. Tata McGraw-Hill, New Delhi.

Notes

Module – 3: Financial Statements

Objective

This Module is intended to introduce the concepts and practice of preparation of Financial Statements and to enable learner to understand information contained in the published financial statements of companies. It includes the preparation of accounting statements and their uses.

Outcome

At the end of this module, learner will be able to-

- Prepare the financial statements with ease
- Analyze & draw conclusion from unstructured numerical problems & financial statements
- Describe the impact of journal entries on financial statement.

> ***"Nearly every business enterprise has accounting system. It is a means of collecting, summarizing, analyzing and reporting in monetary terms, information's about business".***
>
> According to R.N Anthony-

3.1 Introduction to Financial Statements

Financial Analysis is defined as being the process of identifying financial strength and weakness of a business by establishing relationship between the elements of balance sheet and income statement. The information pertaining to the financial statements is of great importance through which interpretation and analysis is made. It is through the process of financial analysis that the key performance indicators, such as, liquidity solvency, profitability as well as the efficiency of operations of a business entity may be ascertained, while short term and long term prospects of a business may be evaluated. Thus, identifying the weakness, the intent is to arrive at recommendations as well as forecasts for the future of a business entity.

Meaning of Financial Statements

Financial statements are the essential documents of business. They are the outputs of financial accounting. They are the final products of the accounting process. They are statements containing financial information of a business Company. They convey certain message to feel financial pulse of an organization. The basic purpose of preparing financial statements is to convey information about financial position of the Company to owners, creditors and the investors.

Nature of Financial Statements

The following characteristics of financial statements indicate their nature:

1. ***Recorded Facts***- The term recorded facts refers to the data drawn from

Notes

accounting records. Only those facts which have been recorded in the books are shown in the financial statements.

2. ***Accounting Principles*** - In the preparation of financial statements, certain accounting principles, concepts and conventions are followed. For example: The principle of cost price or market price whichever is less is followed for valuation of stock.
3. ***Assumptions*** - Business transactions are recorded on certain assumptions. For example: In preparing financial statements, the accountants make many assumptions like that the value of money remains constant, going concern concept etc.
4. ***Personal Judgment*** - The financial statements are affected by the personal judgment of accountants. For example: The method of stock valuation, method of depreciation etc. depend on the personal judgment of the accountant. The accountant can select one of the available methods of stock valuation, depreciation etc.

Essentials of Financial Statements

The financial statements should possess the following essential qualities:

1. ***Understandability*** - Financial statements should be easily understandable by users. For this, the information contained in these statements should be clear and simple.
2. ***Relevance*** - The financial statements must contain only relevant information. Then only the users can evaluate past, present and future events and can take wise decisions.
3. ***Reliability and Accuracy*** - Financial statement should disclose information in such a way that the users can compare the current year's progress with that of previous year. Users must also be able to compare the financial performance of reporting Company with that of other companies.
4. ***Comparability*** - Financial statements should disclose information in such a way that the users can compare the current year's progress with that of previous year. Users must also be able to compare the financial performance of reporting Company with that of other companies.
5. ***Completeness*** - The information contained in the financial statements should be complete in all respects. This means all information should be shown in these statements. It further means that the information shown in the financial statements should not mislead creditors, investors and other users.
6. ***Timeliness*** - The financial statements should be prepared within a reasonable time after the accounting period is over. If the statements are not prepared and presented in time, they cannot be properly used. Besides, the firm cannot formulate plans for future.

3.2 Manufacturing account

It shows the production cost or transfer price of goods completed during the accounting period.

Notes

- ***Direct materials***: Direct Material is that material which can be conveniently identified with a particular cost unit. It is a part of the finished product. For example, cotton used in textile mills. Steel used in manufacturing machines, familiar used in manufacturing furniture, leather used in marking shoes etc.
- ***Direct labour:*** The labour cost incurred on the workers who are directly involved in the production activities of converting raw materials into finished goods are called direct labour cost. Example: Wages paid to workers engaged in manufacturing department, assembling.
- ***Direct expenses***: Direct expense is an expense incurred that varies directly with changes in the volume of a cost object. A cost object is any item for which you are measuring expenses, such as products, product lines, services, sales regions, employees and customers.

This account is prepared before the trading account. The balance of this account is transferred to Trading Account. The proforma of Manufacturing Account is given as-

Pro forma of Manufacturing Account (for the year ending...........)

Particulars	(₹)	Particulars	(₹)
To Opening Stock		By Closing Stock	
Raw Materials		Raw materials	
Work-in-progress	....	Work-in-progress	....
To Purchase of materials		By Sale of Scrape	....
Less returns	....	By Cost of Production (Transferred to Trading A/c)	....
To Manufacturing Wasges	....		
To Carriage Inwards	....		
To Factory Expenses	....		
To Stores Consumed	....		
To Factory Rent	....		
To Electricity	....		
To Depreciation on Plant	....		
To Repairs of Plant	....		
To Works Manager's Salary	....		
To Coal and Fuel	....		
To Other Factory exps.	....		
	....		....

3.4 Trading Account (Overview & Format)

Trading account is the outcome of Trial Balance. The debit balances of Trial Balance would represent either Assets or Losses, and the credit balances either Liabilities or Gains. Trading account is prepared to know the trading results, how much Gross Profit or Gross Loss derived in business concern for a given particular period.

Notes

Trading account includes only such transactions which are related with goods, such as opening stock, closing stock, purchase of goods, sales of goods, purchase returns sales returns, manufacturing expenses, and other direct expenses. Finally trading account is merely the result of trading i.e, involve purchasing and selling of goods.

Objectives of Trading Account

The main objectives of trading accounts are as follows:

(i) To know the gross results arising from the buying and selling of goods.

(ii) To identify the weak spots of the firm by comparing purchases, sales and stock of one period with similar items of the preceding period.

(iii) To know information about ratio of gross profit to the turnover, in order to get result how far have been achieved.

(iv) To know information on the direct expenses of which percentage bear to gross profit.

3.5 Preparation of Trading Account

Trading account is prepared by only those transactions which depend on the goods. The items which are directly involved in the trading account are-

(i) Opening Account

(ii) Purchase and Purchase Returns

(iii) Sales and Sales Returns

(iv) Direct Expenses

(v) Closing Stock

Structure of Trading Account

Trading account of XYZ Company for the year ending on ....

Dr.					Cr.
Particulars		Amount	Particulars		Amount
To Opening stock		xxx	By Sales	xx	
To Purchase	xx		Less: Returns	xx	xxx
Less: Returns	xx	xxx	By Closing stock		xxx
To Direct expenses:			By Gross Loss		xxx
Wages	xx		[Transfer to P & L A/c]		
Factory Expenses	xx				
Carriage inwards	xx				
Cartage	xx				
Freight	xx				
Factory rent	xx				
Belting	xx				

Notes

Motive Power	xx				
Tallow & Oil, Coal & Coke, Gas & Water	xx				
Excise duty	xx				
Dock charges	xx				
Octroi chanrges	xx				
Royalties	xx				
To Gross Profit		xxx			
(transfer to P&L A/c					
		xxx			xxx

3.6 Profit and Loss Account

Profit and loss account is the outcome of both trial balance and trading account. Profit and loss account is prepared to know the business results, how much net profit or net loss derived in the business concern for a given financial year.

After ascertaining gross profit or gross loss from trading account it would be transferred to the profit and loss account on the credit side and debit side respectively. Profit and loss account includes only such transactions which are miscellaneous incomes like; interest, commission, dividend, discount, profit on exchange, rent received etc., on the credit side of profit and loss account also includes all the expenses incidental to the carrying on the business such as office rent, salaries, insurance, stationary and printing, telephone expenses, audit fees, advertising, carriage outwards, sales tax, repairs and renewals, entertainment expenses, legal charges, etc. on the debit side.

Objectives of Profit and Loss Account

- To ascertain the net profit or net loss in certain period of time in business entity.
- To compare the profit and loss of the current year with the previous year.
- To know information on the indirect expenses of which percentage bear to gross profit.
- To know the net profit ratio to asset turnover, in order to getting results how far have been achieved.

3.7 Preparation of Profit and Loss Account

Profit and loss account is a nominal account and as such all the indirect expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side as per nominal account rules, "Debit all expenses and losses, credit all incomes and gains.

Particulars	Amount	Particulars	Amount
To Gross Loss	xxx	By Gross Profit (transferred	xxx

Notes

(transferred from trading account)		from trading account)	
To Administration expenses:		By Cash discounts earned	
Salaries	xx	By Income from investment	
Wages	xx	Dividend on shares	
Rent & Taxes	xx	Miscellaneous	
Office Lighting	xx	Interest on money deposit	
Printing & Stationery	xx	By Bad debts recovered	
Telephone charges	xx	By Commission received	
Fees & Expenses	xx	By Income from other sources	
Postage & Telegrams	xx	By Profit earned on sales of assets	
Audit fees	xx	By Net Loss	
Office car keeping	xx	(Transferred to Balance sheet)	
Office general expenses	xx	xxx	
To Selling and distribution exp:			
Ware house and Store rent	xx		
Packing expenses	xx		
Freight and Carriage			
outwards	xx		
Sampling expenses	xx		
Cost of catalogues	xx		
Bad debts	xx		
Commission	xx		
Advertisement	xx		
Export expenses	xx		
Insurance premium	xx		
Brokerage	xx		
Noting charges	xx		
To Financial Expenses	xx		
Discount allowed	xx		
Interest on capital			
Loss in exchange			
Discounting bill			
Discount on issue			
Of debentures			
To Net Profit			

Notes

3.8 Introduction to Balance Sheet

Balance Sheet is a statement which reflects the true position of assets and liabilities on a particular period. It is also known as financial statement.

In view of the fact that the assets and liabilities changes from day to day as a result of business transactions, the trader must necessarily feel anxious to find out what his true financial position is at the end of each trading period. In the first place, he would like to know whether the net profit as is disclosed by the profit and loss account is correctly arrived at, for, if so, his capital at the end of the period must necessarily increase by that amount. He is equally anxious to see for himself as to how such capital is made up, i.e., what the component assets and Liabilities of the business are. In order, therefore, to obtain this information at the end of the trading period he has to set out his several assets and liabilities as at that date in the shape of a statement and this statement is called the Balance Sheet.

Balance sheet is prepared from the Trial balance, after all the balances on nominal account are transferred to the trading and profit and loss account and corresponding account in the ledger are closed. The balances now left in the trial balance and remaining one in the ledger represent either personal or real account. All assets and liabilities are set out in the balance sheet in a systematic manner. In the right side are shown the assets and on the left-hand side are shown the various liabilities.

Finally, balance sheet shows the true financial position of the business on a specific date i.e., at the end of an accounting period the total assets and total liabilities must be equal.

Definitions

According to T.R. Batliboi, "A balance sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date".

In the words of 'Free man,' A balance sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain data.

According to Palmer, "A balance sheet is a statement at a particular date showing on one side the trader's property and possessions and on the other side the liabilities

Objectives of a Balance Sheet

- To find out the financial position of the business firm for a particular financial period.
- To know the sources and applications of the fund.
- To act as an effective communication tools for stake holder. (Creditors, government, income tax authority's and general public) etc.
- To assists in decision making for future course of action.
- To obtain the information about assets (economic resource control by the entity that are expected to provide further benefits) and liabilities.

Notes

3.9 Preparation of a Balance Sheet

While preparing a balance sheet the following steps must be considered. Balance sheet is known as liabilities on the left hand side, assets on the right hand side, instead there is no debit side or no credit side in the balance sheet.

In the balance sheet the debit balances of trial balances of personal and real accounts are to be shown on the assets side and the credit balances of personal accounts are to be shown on the liabilities side. It is prepared on a specific data i.e. at the end of accounting period. So use the word as on.... or as at. in the heading of Balance sheet instead of "For the year ended.". Finally, thus the word 'To' and 'By' are not shown in the balance sheet.

Structure of a Balance Sheet as on…

Liabilities		Amount	Assets	Amount
Current Liabilities:			**Current Assets:**	
Bank Overdraft		xxx	Cash in hand	xxx
Bills Payable		xxx	Cash at Bank	xxx
Outstanding expenses		xxx	Bills Receivable	xxx
Income received in advance		xxx	Prepaid expenses	xxx
Sundry Creditors		xxx	Accrued Income	xxx
Short term loans		xxx	Investment	xxx
Fixed Liabilities:			Sundry Debtors	xxx
Long term loan		xxx	Stock (closing)	xxx
Reserves		xxx	Loose Tools	xxx
Capital			**Fixed Assets:**	xxx
Add: Net profit	xxx		Goodwill	xxx
Add: Interest on Capital	xxx		Furniture & Fixture	xxx
Less: Drawings	xxx		Plant & Machinery	xxx
	xxx		Long term Investment	xxx
Less: Interest on Drawings	xxx	xxx		
		xxx		**xxx**

Alternative Structure of a Balance Sheet as on …

Liabilities		Amount	Assets	Amount
Capital	xxx		**Fixed Assets:**	xxx
Add: Net profit	xxx		Goodwill	xxx
Add: Interest on capital	xxx		Furniture & Fixture	xxx
Less: Drawing	xxx		Plant & Machinery	xxx
			Long term Investment	xxx

Notes

Less: Interest on Drawings	xxx	xxx	**Current Assets:**	
Fixed Liabilities:			Cash in hand	xxx
Long term loan		xxx	Cash at Bank	xxx
Reserves		xxx	Bills Receivable	xxx
Current Liabilities:			Prepaid expenses	xxx
Bank Overdraft		xxx	Accrued Income	xxx
Bills payable		xxx	Investment	xxx
Outstanding expenses		xxx	Sundry Debtors	xxx
Income received in advance		xxx	Stock (closing)	xxx
Sundry Creditors		xxx	Loose Tools	xxx
Loan		xxx		

Example:

From the following following particulars prepare a Balance Sheet for the year ended 2rd May, 2011.

Particulars	(₹)
Land and Building	80,000
Capital	1,90,000
Plant and Machinery	1,20,000
Net Profit	20,000
Sundry Creditors	48,000
Cash at Bank	10,000
Bills Payable	9,000
Sundry Debtors	20,000
bills Receivable	7,000
Cash in hand	30,000

Solution:

Balance Sheet for the year ended 31st May, 2011

Liabilities		(₹)	Assets	(₹)
Capital	1,90,000		Land & Building	80,000
Add: Net Profit	20,000	2,10,000	Plant & Machinery	1,20,000
Sundry Creditors		48,000	Bills Receivable	7,000
Bills Payable		9,000	Cash at bank	10,000
			Cash in hand	30,000
			Sundry Debtors	20,000
		2,67,000		**2,67,000**

Notes

Numerical for practice

Example:

From the following information of Chandrashekar, prepare final Accounts for the year 31st March 2006.

Particulars	Amount	Particulars	Amount
Drawings	4,500	Trade expenses	300
Purchases	20,000	Printing	150
Returns Inwards	1,500	Funrniture	2,000
Stock (1-4-2005)	8,000	Machinery	5,000
Salaries	4,200	Bad debts	400
Wages	1,200	Discounts	700
Rent	350	Sundry Debtors	14,000
Cash in hand	260	Insurance	400
Cash in Bank	5,940	Sales	30,500
Capital	24,000	Discounts	1,900
Sundry Creditos	10,000	Bills payable	2,500

Adjustment:

a) Closing stock ₹ 7,000

b) Insurance Prepaid ₹ 60

c) Outstanding liabilities: salaries ₹ 200, wages ₹ 200

d) Make provision for doubtful debts at 5% on debtors

e) Calculate inerest on capital at 5% p.a.

f) Depreciate Machinery at 5% and Furniture at 10%

g) Reserve for discount on creditors at 1%

Trading and Profit & Loss Account of Chandrashekar for the year ended 31st Mar. 2006

Particulars		₹	Particulars		₹
To Opening Stock		8,000	By Sales	30,500	
To Purchases		20,000	Less: RIW	1,500	29,000
To Wages	1,200		By Closing stock		7,000
Add: O/s wages	200	1,400			
To Gross profit c/d		6,600			
		36,000		36,000	
To Salaries	4,200		By Gross profit b/d		6,600

Notes

Add: O/s salaries	200	4,400	By Discount		1,900
To Rent		350	By Reserve for Dist. on creditors		100
To Insurance	400		By Net loss (transferred to capital)		390
Less: Prepaid	60	340			
To Trade expenses		300			
To Printing		150			
To Discount		700			
To Interest on capital		1,200			
To Depreciation on					
a) Machinery		250			
b) Furniture		200			
To Bad debts	400				
Add: Provision for DD	700	1,100			
		8,990			8,990

Chandrashekar's Balance Sheet as on 31st March 2006

Particulars		₹	Particulars		₹
Sundry creditors	10,000		Land & Building		260
Less Reserve for Dist.	100	9,900	Cash at bank		5,940
Bills payable		2,500	Sundry debtors	14,000	7,000
O/s expenses:			Less: Provision for DD	700	13,300
Salary	200	6,600			
Wages	200	400	Closing stock		7,000
Capital	24,000		Prepaid insurance		60
Add: Int. on capital	1,200		Machinery	5,000	
	25,200		Less: Dept.	250	4,750
Less: Net loss	390		Furniture	2,000	
	24,810		Less: Dept.	200	1,800
Less: Drawings	4,500	20,310			
		33,110		33,110	

Example:

Prepare the Profit and Loss Account from the following particulars relating to the year ending 30th April 2011

Particulars	(₹)
Office Salaries	40,000
Postage and Telegrams	20,000
Office Rent	7,000
Sundry Office expenses	10,000

Notes

Selling expenses	8,000
Gross Profit	2,00,000
Advertisement	12,000
Commission paid	9,000
Commission received	8,000
Prepaid Rent	1,000
Outstanding Salaries	15,000

Solution:

Profit and Loss Account for the year ended 30th April 2011

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Office Salaries	40,000	By Gross Profit	2,00,000
To Postage and Telegrams	20,000	By Commission received	8,000
To Sundry Office Expenses	10,000		
To Selling Expenses	8,000		
To Advertisement	12,000		
To Commission Paid	9,000		
To Office Rent	7,000		
To Net Profit (Transfer to Capital A/c)	1,02,000		
	2,08,000		**2,08,000**

Note: Prepaid Rent & outstanding salary is as treated assets or liability respectively. So they are not entered into profit & loss account.

Example:

Prepare Profit and Loss Account from the following particulars relating to the year ending 29th Feb. 2011

Particulars	(₹)
Gross Profit	1,40,000
Salaries	28,000
Administration expenses	10,000
Selling expenses	20,000
Maintenance expenses	5,000
Commission received	7,000
Sundry Office expenses	10,000

Notes

Solution:

Profit and Loss Account for the year ended of 29th Feb. 2011

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Salaries	28,000	By Gross Profit	1,40,000
To Administration expenses	10,000	By Commission received	7,000
To Selling expenses	20,000		
To Maintenance expenses	5,000		
To Sundry office expenses	10,000		
To Net Profit (Transfers to capital a/c)	74,000		
	1,47,000		**1,47,000**

Key Takeaways:

- ***Financial statement analysis:*** It is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account
- ***Financial statements***: There are the essential documents of business.
- ***Trading account***: It is the outcome of Trial Balance.
- ***Profit and loss account:*** It is a nominal account and as such all the indirect expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side
- ***Balance Sheet***: It is the statement reflecting the true position of assets and liabilities on a particular period.

Check your progress:

1. Process of identifying financial strengths and weaknesses of the firm is:
   a) Accounting Fundamentals
   b) Financial ratio analysis
   c) Computation of balance sheet
   d) Financial Statement Analysis
2. _______________ is the outcome of a trial balance.
   a) Balance Sheet
   b) Trading Account
   c) Ledger
   d) Journal
3. There are the essential documents of business.
   a) Accounting Fundamentals

Notes

b) Financial ratio analysis

c) Computation of balance sheet

d) Financial Statement

4. Statement reflecting the true position of assets and liabilities is?

a) Balance Sheet

b) Trading Account

c) Ledger

d) Journal

5. ____________ is also known as financial statement.

a) Balance Sheet

b) Trading Account

c) Ledger

d) Journal

Questions & Exercises

1. What are financial statements? Explain the tools and techniques.
2. Explain balance sheet and its objectives.
3. What is a P/L account? What are its objectives?
4. What are the objectives of a trading account?
5. What are the essentials of a financial statement?

Check your progress

1. d) Financial Statement Analysis
2. b) Trading Account
3. d) Financial Statement
4. a) Balance Sheet
5. a) Balance Sheet

Further Readings

1. Horngren.C.T., *Accounting For Management Control* - An Ntroduction, Englewood Cliffs, Prentice Hall, 1965.
2. Maheswari, S.N., *Management Accounting*, Sultan Chand & Sons, New Delhi.
3. Hingorani, Ramanathan & Grewal, *Management Accounting*.
4. Jain S.P. And Narang, K.L., *Cost Accounting. 8. Financial Accounting*, Tulsian. Tata McGraw-Hill, New Delhi.

Notes

Module - 4: Financial Statement Analysis

Objective

This module is designed to explain how financial measures of corporate performance are calculated and used to assess credit worthiness of a business with the help of techniques of financial statement analysis. The module covers the basics of financial statement analysis and enables participants to confidently use financial terminology.

Outcome:

At the end of this module, learner will be able to understand-

- The basic techniques of financial statement analysis.
- How a company's business and financing activities are reflected in its financial statements.
- The components of financial statements: Balance sheet, profit and loss and cash flow and key notes to the accounts.
- The distinction between cash flow and profits & how to measure operating, investing and financial performance using appropriate ratios and cash flow tools.

> ***"Accounting may be defined as the collection, compilation and systematic recording of business transactions in terms of money, the preparation of financial reports, the analysis and interpretation of these reports and the use of these reports for the information and guidance of management"***
>
> According to A. W. Johnson-

4.1 Introduction to Financial Statement Analysis

The chief function of financial statements is providing valuable information about financial position and operating strength or weakness of the Company to various parties interested in the Company. The various interested parties are management, investors, creditors, banks, employees, government, customers, public, trade associations, stock exchanges etc. They are the users of the financial statements and financial statement analysis are actually the vehicles through which the financial information are transported to users of financial information. The following are the uses of financial statements to different parties are:

1. ***Importance for Management (Owners)*** - Financial statements supply valuable information to owners or management. They make use of financial statements for ascertaining the earning capacity, financial position, growth etc. Management can take decisions and manage the business efficiently on the basis of information provided by financial statement.
2. **Importance for Investors** - In the case of Joint Stock Company, shareholders and long term leaders (debenture holders) are the investors. Shareholders are the real owner of joint stock companies. Shareholders need information to decide whether

Notes

to buy, hold or sell shares of the Company. They also need information regarding financial position, earning of the firm. Debenture holders need information to know whether the Company has ability to repay the debt and to pay the interest. The information required by investors is provided by financial statements.

3. ***Importance for Trade Creditors or Suppliers*** - Trade creditors or suppliers need information to determine whether amounts owing to them will be paid when due. Financial statements help them to know whether the Company has the capacity to pay the amount due to them in time.

4. ***Importance for Banks*** - Banks will ensure that their loans along with interest will be paid on due dates while granting loans. For this, they want to know about the financial position and profit earning capacity of the borrowing Company. Banks will get the required information from the financial statements.

5. **Importance for Customers** - Customers needs information to know whether the Company will be able to continue supply of goods and services to them. For knowing this, financial statements come to their help.

6. ***Importance for Employees*** - Employees requires information to assess the profitability and stability of the Company. The profitability of the Company affects the remuneration, bonus, retirement benefits, working conditions etc. of the employees. Therefore, the employees are also interested in the financial statements.

7. ***Importance for Government and Agencies*** - Governments need information about the affairs of a Company to formulate tax policies, export-import policies, annual budget etc. Controlling agency like SEBI is interested in the financial statements of businesses to exercise control over them better. Similarly, tax authorities are also interested in income statements of the taxpaying companies. The income statement provides the basis for assessing the taxable income.

8. ***Importance for Public*** - General public is also interested in financial statements of their business.. Financial statements provide information to public to judge whether a company has fulfilled its social responsibility or not.

9. ***Importance for Trade Unions*** - Trade unions requires information to initiate wage negotiations. This information is provided by financial statements. Financial statements are also important for stock exchanges, research scholars etc. Thus, financial statements are able to satisfy the needs of all the parties interested in the business.

4.2 Limitations of Financial Statement Analysis

The limitations of financial statements are the factors that a user must be aware of before relying on them to an excessive extent. Knowledge of these factors can result in a reduction of invested funds or actions taken to investigate further. The following are the limitations of financial statements:

1. ***Dependence on historical costs***. Transactions are initially recorded at their cost. This is a concern when reviewing the balance sheet, where the values of assets and liabilities may change over time. Some items, like the marketable securities, are altered to match changes in their market values, but other items, such as fixed assets, do not change. Thus, the balance sheet could be misleading if a large part of the amount presented is based on historical costs.

Notes

2. ***Inflationary effects.*** If the inflation rate is relatively high, then the amounts associated with assets and liabilities in the balance sheet will appear inordinately low, since they are not being adjusted for inflation. This mostly applies to long-term assets.
3. ***Intangible assets not recorded***. Many intangible assets are not recorded as assets. Instead, any expenditure made to create an intangible asset is immediately charged to expense. This policy can drastically underestimate the value of a business, especially one that has spent a large amount to build up a brand image or to develop new products. It is a particular problem for startup companies that have created intellectual property, but which have so far generated minimal sales.
4. ***Based on specific time period***. A user of financial statements can gain an incorrect view of the financial results or cash flows of a business by only looking at one reporting period. Any one period may vary from the normal operating results of a business, perhaps due to a sudden spike in sales or seasonality effects. It is better to view a large number of consecutive financial statements to gain a better view of ongoing results.
5. ***Not always comparable across companies***. If a user wants to compare the results of different companies, their financial statements are not always comparable, because the entities use different accounting practices. These issues can be located by examining the disclosures that accompany the financial statements.
6. ***Subject to fraud***. The management team of an enterprise may deliberately skew the results presented. This situation can arise when there is undue pressure to report excellent results, such as when a bonus plan calls for payouts only if the reported sales level increases. One might suspect the presence of this issue when the reported results spike to a level exceeding the industry norm, or well above the enterprise's historical trend line of reported results.
7. ***No discussion of non-financial issues***. The financial statements do not address non-financial issues, such as the environmental attentiveness of an enterprise's operations, or how well it works with the local community. A business reporting excellent financial results might be a failure in other areas.
8. ***Not verified***. If the financial statements have not been audited, this means that no one has examined the accounting policies, practices, and controls of the issuer to ensure that it has created accurate financial statements. An audit opinion that accompanies the financial statements is evidence of such a review.
9. ***No predictive value***. The information in a set of financial statements provides information about either historical results or the financial status of a business as of a specific date. The statements do not necessarily provide any value in predicting what will happen in the future. For example, a business could report excellent results in one month, and no sales at all in the next month, because a contract on which it was relying has ended.

4.3 Techniques of Financial Statement Analysis

Tools and Techniques of Financial Statement Analysis:

Following are the most important tools and techniques of financial statement analysis:

Notes

- ***Horizontal and Vertical Analysis:*** Horizontal Analysis or Trend Analysis: Comparison of two or more year's financial data is known as horizontal analysis, or trend analysis. Horizontal analysis is facilitated by showing changes between years in both dollar and percentage form.
- ***Trend Percentage:*** Horizontal analysis of financial statements can also be carried out by computing trend percentages. Trend percentage states several years' financial data in terms of a base year. The base year equals 100%, with all other years stated in some percentage of this base.
- ***Vertical Analysis:*** Vertical analysis is the procedure of preparing and presenting common size statements. Common size statement is one that shows the items appearing on it in percentage form as well as in dollar form. Each item is stated as a percentage of some total of which that item is a part. Key financial changes and trends can be highlighted by the use of common size statements.

4.4 Ratio Analysis

The ratios are based on that technique. The ratios are the relation between the different accounting figures. Analysis of the ratio allows the management and other users of the financial statements in assessing the viability of the Company and its financial status. From this analysis, profitability, solvency, liquidity and business efficiency can be easily determined.

4.5 Types of Ratios- Liquidity Ratio

To study the short-term solvency or liquidity of the firm, there are two ratios:

1. Current Assets Ratio
2. Acid Test Ratio or Quick Assets Ratio

1. Current Assets Ratio

The current ratio is also known as the working capital ratio and is normally presented as a real ratio. In order to survive, firms must be able to meet their short-term obligations—pay their creditors and repay their short-term debts. Thus, the liquidity of the firm is one measure of a firm's financial health. This is the ratio establishes the relationship in between the current assets and current liabilities.

Current Ratio = Current Assets/ Current Liabilities

Current Assets include Cash + Bank balances + Marketable Securities + Stock + Accrued/Outstanding Incomes + Prepaid Expenses while Current Liabilities include Creditors + Short term debt + outstanding expenses and unearned income etc.

A big limitation of current ratio is that the current assets are equally weighed against each other to match the current liabilities.

Example:

Company ABC has current assets worth Rs. 5 lac, while the liabilities amounting to Rs. 2 lac. What is the current ratio of the firm?

Current Ratio = Current Assets/ Current Liabilities

Notes

Current Ratio = 5/2

= 2.5

2. Acid test ratio

The acid test ratio is also known as the liquid or the quick ratio. The ratio expresses the relation between the quick assets and the current liabilities. The ratio is used to replace the related bottleneck with the current ratio. It considers the liquid assets that can quickly be converted into cash to satisfy the financial obligations.

Acid Test Ratio = Liquid Assets/ Current Liabilities

Example:

Company XYZ has a closing stock of ` 30,000 while its prepaid expenses are 10,000. What will be its quick assets ratio if the current assets are worth 55000 while current liabilities are worth ` 15000?

Solution:

Liquid Asset = Current Assets – (Closing Stock + Prepaid Expenses)

= 55000 – (30000 + 10000)

= 15000

Acid Test Ratio = Liquid Assets/ Current Liabilities

= 15000/15000

= 1:1

4.6 Leverage Ratio

These ratios indicate the ability of the Company to fulfill its long term obligations. Those ratios are therefore also known as long-term solvency ratios. A Company's long-term debt covers debentures, long-term loans, unpaid hire-purchase installments and long-term creditors. Contribution of the shareholders through equity capital, preference share capital and past accumulated profits. It reveals the cover or cushion that the firm has enjoyed because of the contribution of the owners over the contribution of the outsiders.

Debt equity ratio = Debt (Long term Debt) / Net worth (Equity or Shareholder's funds)

- ***Total Debt equity ratio***

The purpose of the ratio is to express the relationship of the total volume of debt irrespective of its nature and the shareholders' funds. If the contribution of owner is lesser in volume in general, it leads to a worse situation in recovering the contribution amount of outsider during liquidation.

Total Debt equity ratio = Short Term Debt + Long term Debt / Equity (Shareholder's funds)

Example:

The long-term debt of company ABC is 3 crores and the shareholders fund of the company is 5 crores. If the company has a short-term debt of 1 crore, what is the total debt equity ratio of ABC?

$$\text{Total Debt-equity Ratio} = \frac{\text{Short-term Debt + Long-term Debt}}{\text{Equity (Shareholders' Fund)}} = \frac{4}{5} = 0.8 \text{ and } 80\%$$

4.7 Activity Ratio

Activity ratios or the turnover ratios highlight the relationship between the sales and various assets. It indicates the speed which is taken by the firm to convert their assets into sales.

- ***Stock Turnover Ratio***

  The ratio expresses the speed of converting the stock into sales. It determines as to how fast the stock is being converted into sales in a year. The greater the ratio of conversion leads to lesser the number of days, weeks or the months required to convert the stock into sales.

  Stock Turnover Ratio = COGS/ Average Stock or Sales/ Closing Stock

- ***Debtors Turnover Ratio***

  The ratio exhibits the speed of the collection process of the firm. Represents the collected amount of the overdues from the debtors and against the bills receivables. The speediness is being computed through debtor's velocity from the ratio of Debtors Turnover Ratio.

  Debtor Turnover Ratio = Net Credit Sales/ Average Debtors

- ***Creditors Turnover Ratio***

  It shows effectiveness of the firm in deploying the credit period allowed by the creditors during the moment of a credit purchase.

  Credit Turnover Ratio = Credit Purchase/ Average Creditors

4.8 Profitability Ratios

These ratios are measurement of the firm's profitability in three dimensions namely the sales, investments and on capital employed.

Profitability ratios are a class of financial metrics used over time to measure the ability of a corporation to produce profits compared to its sales , operating expenses, balance sheet assets, or equity of shareholders, using data from a particular point in time.

a. Gross profit ratio

The ratio elucidates the relationship in between the gross profit T. and the sales volume. It determines the profit earning capacity of the firm out of the manufacturing or trading operations.

Gross Profit Ratio = Gross Profit/ Sales × 100

Remember: Turnover = Sales Gross Profit = Net Sales - Cost of Sales Cost of Sales = Opening Stock + Net Purchases + Other Direct Expenses – Closing Stock

Notes

The gross profit margin ratio tells us the profit a business makes on its cost of sales, or cost of goods sold. It is a very simple idea and it tells us how much gross profit per Rs1 of turnover our business is earning. Gross profit is the profit we earn before we take off any administration costs, selling costs and so on. So we should have a much higher gross profit margin than net profit margin.

Example – ABC Companies has earned a gross profit of ` 4,00,000 in the first quarter. Calculate the gross profit ratio if the corresponding sales amounted to a value of ` 20,00,000. What does it imply?

Gross Profit Ratio = Gross Profit/ Sales × 100

Gross Profit Ratio = 4,00,000/ 20,00,000 × 100

= 20%

b. Net profit ratio

The ratio expresses the relation between the net profit and the amount of the sales. It facilitates the representation of the Company's overall operational effectiveness. The net profit ratio is an indicator of the firm's overall earning capacity in terms of sales volume return.

Net Profit Ratio = Net Profit/ Sales × 100

Example – ABC Company has earned a gross profit of Rs. 4,00,000 in the first quarter. Calculate the gross profit ratio if the corresponding sales amounted to a value of Rs. 40,00,000. What does it imply?

Net Profit Ratio = Net Profit/ Sales × 100

Net Profit Ratio = 4,00,000/ 40,00,000 × 100

= 10%

c. Operating Profit Ratio

The operating ratio is establishing the relationship in between the cost of goods sold and operating expenses with the total sales volume.

Operating Ratio = Cost of Goods Sold + Operating expenses/ Net Sales × 100

d. Return on Assets Ratio

This ratio demonstrates the relationship between the profits and the total assets employed in the business. The ratio also highlights the firm's successful use of assets by assessing the return on total assets hired.

Return on Assets = Net profit after taxes/ Average total assets × 100

Example:

If Company XYZ has an income of ₹1 crore and total assets of ₹10,00,000, what will be the return on assets if net profit t after taxes is ` 500000?

Return on Assets = Net profit after taxes/ Average total assets × 100

= 5,00,000/1,00,0000 × 100

= 50%

Notes

e. Return on Capital Employed

The ratio indicates how much return is received out of the total capital employed in the form of Net profit after taxes. The capital employed is nothing but a blend of the non-current liabilities and the equity of the shareholders. The ratio expresses the relation between the total after-tax earnings and the total capital employed

Return on total capital employed = Net profit after taxes/ Total capital employed × 100

4.9 Ratio Analysis (Numerical/Illustration)

The following is the balance sheet of a company as on 31-3-19.

Liabilities	Rs.	Assets	Rs.
Equity Share	40,00,000	Land & Buildings	40,00,000
Reserves & Surplus	20,00,000	Plant & Machinery	40,00,000
Debentures	30,00,000	Investments	30,00,000
Long term loans	50,00,000	Stock	25,00,000
Creditors	8,00,000	Debtors	15,00,000
Other current liabilities	12,00,000	Other current assets	10,00,000
	1,60,00000		1,60,00000

Calculate:

a. Current ratio

b. Stock to working capital ratio

c. Debt-Equity ratio

d. Net-worth ratio/properietor/ratio

e. Fixed assets to net worth ratio

f. Current assets to net worth ratio

g. Solvency ratio

Current ratio = Current Assets/Current Liabilities = 50,00,000 / 20,00,000 = 2.5

Stock to working capital ratio = Stock/Inventory/Working capital x 100 Working capital = Current Assets + Current Liabilities

= 50,00,000 = 20,00,000 = 30,00,000

= 25,00,000/30,00,000 x 100 = 83.33%

Debt-equity ratio = Debt/Equity

Debt = Long-term loans 30,00,000+50,00,000=80,00,000

Equity = Share Capital + Reserves + Surplus

Notes

	=	40,00,000 + 20,00,000 = 60,00,000
	=	80,00,000 / 60,00,000 = 1.33
Net worth or proprietary ratio	=	Net worth (equity) / Total assets
(Net worth)	=	Share capital = Reserves & Surplus
	=	60,00,000 / 1,60,00,000 = 0.375
Fixed assets to net worth ratio	=	Net fixed assets
	=	80,00,000 / 60,00,000 = 1.33
Current assets to net worth ratio	=	Current assets/Net worth
	=	50,00,000 / 60,00,000 = 0.833
Solvency Ratio	=	Total assets / Total liabilities
Total assets	=	total of asset side of balance sheet.
Total liabilities	=	Both long-term and current liabilities
	=	1,60,00,000 / 1,00,00,000 = 1.6

4.10 Introduction to Comparative Analysis

Every business needs to prepare basic financial statements that summarize its operating results and financial position for a particular period. These statements primarily include income statements, balance sheets, and cash flow statements.

To calculate the financial relationships between variables over two or more reporting periods, it is done the using comparative analysis. Comparative analysis is used by businesses as a way of defining their competitive positions and operating performance over a given span.

This analysis helps to understand the relationship between various components showcased in each of these statements. So, one of the tools commonly used to undertake financial statement analysis is creating comparative financial statements. Other techniques include:

- Common Size Statement Analysis
- Ratio Analysis
- Cash Flow Analysis
- Trend Analysis

Features of Comparative Analysis

1) A comparative statement adds meaning to the financial data.
2) It is used to effectively measure the conduct of the business activities.
3) Comparative statement analysis is used for intra firm analysis and inters firm analysis.
4) A comparative statement analysis indicates change in amount as well as change in percentage.

Notes

5) A positive change in amount and percentage indicates an increase and a negative change in amount and percentage indicates a decrease.

6) if the value in the first year is zero then change in percentage cannot be indicated. This is the limitation of comparative statement analysis. While interpreting the results qualitative inferences need to be drawn.

7) It is a popular tool useful for analysis by the financial analysts

8) A comparative statement analysis cannot be used to compare more than two years financial data.

4.11 Comparative Analysis (Numerical/Illustration)

Here is an example of a comparative balance sheet that contains the Balance Sheets of ABC Ltd. for the year ending 31st Dec. 2019 and 2020 are as follows:

ABC International Statement of Financial Position

Liabilities	31st Dec. 2019 (₹)	31st Dec. 2020 (₹)	Assets	31st Dec. 2019 (₹)	31st Dec. 2020 (₹)
Equity Share Capital	8,000	10,000	Land & Building	4,000	6,000
Capital Reserve	300	1,800	Plant & Machinery	2,000	3,000
10% Debentures	1,200	1,600	Investment	1,200	1,600
Creditors	500	600	Debtors	800	1,000
			Stock	1,600	1,800
			Cash	400	600
Total	10,000	14,000	Total	10,000	14,000

Solution -

Comparative balance sheet of ABC is as follows -

	31st Dec. 2019 (₹ 000)	31st Dec. 2020 (₹ 000)	Increase or Decrease (₹ 000)	Increase or Decrease in (₹ 000)
Assets: Fixed Assets:				
Land and Building	4,000	6,000	+2,000	$\frac{2000}{4000} \times 100 = 50$
Plant & Machinery	2,000	3,000	+1,000	$\frac{1000}{2000} \times 100 = 50$
Total Fixed Assets	6,000	9,000	3,000	$\frac{3000}{6000} \times 100 = 50$
Investment Current Assets:	1,200	1,600	400	$\frac{200}{600} \times 100 = 33.33$
Debtors	800	1,000	200	$\frac{200}{800} \times 100 = 25$

Notes

Stock	1,600	1,800	200	$\frac{200}{1600} \times 100 = 12.5$
Cash	400	600	200	$\frac{200}{400} \times 100 = 50$
Total of Current Assets	2,800	3,400	600	$(\frac{200}{2800} \times 100) = 21.43$
Total Assets	10,000	14,000	4,000	$\frac{4000}{10000} \times 100 = 40$
Liabilities Equity Share Capital	8,000	10,000	2,00	$\frac{2000}{8000} \times 100 = 25$
Reserve and Surplus	300	1,800	1,500	$\frac{1500}{300} \times 100 = 500$
10% Debentures (Secured Loan)	1,200	1,600	400	$\frac{400}{1200} \times 100 = 33.33$
Total of Fixed Liabilities	9,500	13,400	3,900	$(\frac{3900}{9500} \times 100) = 41.05$
Creditors	500	600	100	$\frac{100}{500} \times 100 = 20$
Total Liabilities	10,000	14,000	4,000	$\frac{4000}{10000} \times 100 = 40$

Example:

Following is the statement of cost of goods manufactured by Raj Co. Ltd. present the data in suitable form for analysis:

	2020 (₹)	2019 (₹)
Raw Materials:		
Opening Stock	46,000	42,000
Purchases	4,74,000	4,30,000
	5,20,000	**4,72,000**
Less: Closing Stock	52,000	46,000
Add: Material Consumed	4,68,000	4,26,000
Direct Labour	6,32,000	5,06,000
Manufacting Expenses	2,84,000	2,42,000
	13,84,000	**11,74,000**
Valuation of Goods in Process of Stock:		
Opening of year	28,000	26,000
closing of year	32,000	28,000
Increase	4,000	2,000
Cost of Goods Munufactured	13,80,000	11,72,000

Solution:

Raj Company Limited Comparative Statement of Cost of Goods Manufactured:

Particulars	Amount		% of cost of Goods Manf.		Increase (+) Decrease (–)	
	2020 ₹ in 000	2019 ₹ in 000	2020	2019	Absolute ₹ in 000	Relative in %
Raw Materials Used	468	426	33.91	36.35	+42	+9.86
Direct Labour	632	506	45.80	43.17	+126	+24.90
Manufacturing Expenses	284	242	20.58	20.65	+42	+17.36
Total	1,384	1,175	100.29	100.17	+210	+17.89
Less Increase in						
Work-in-Progress	4	2	0.29	0.17	+2	
Cost of Goods						
Manufactured	1,380	1,172	100	100	+208	+17.75

The comparative balance sheet reveals that ABC has increased the size of its current assets over the past few years, but has also recently invested in a large amount of additional fixed assets that have likely been the cause of a significant boost in its long-term debt.

4.12 Introduction to Cash Flow Statements

The cash flow statement provides details about a firm's cash flow operations. This statement explicitly includes the Company's acquisition, operation, and financing activities. The cash flow statement displays all sources and uses of cash by a Company over the accounting period. Sources of cash listed on the statement include the revenues, long-term financing, sales of noncurrent assets, and an increase in any current liability or the decrease in any current asset account. Uses of cash include the operating losses, debt repayments, equipment purchases and increases in current asset accounts.

The cash flow statement is intended to -

1. Provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
2. Provide additional information for evaluating changes in assets, liabilities and equity
3. Improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. Indicate the amount, timing and probability of future cash flows.

Benefits --

The uses of financial statements vary from entity to entity and for different users, they have different uses. Presented under is a brief list of benefits they give to their users --

Notes

Notes

1. ***For equity investors and lenders***: Existing equity investors and lenders to a Company need to track their investments and evaluate management performance. In this end, they have no other help than a Company's financial statements. Prospective investors and lenders make use of financial statements to determine whether to invest in an entity or not.
2. ***For finance specialists***: Investment analysts, money managers, and stockbrokers, use financial cash flow statements to make buy, sell and hold the recommendations to their clients.
3. ***For credit rating agencies***: Many rating agencies also assign their credit ratings on the basis of the financial statements of an Company.
4. ***For customers and suppliers***: Major customers and suppliers to an entity measure the financial strength and the Company's staying power as a reliable tool for their sector. In that end, the most possible supports are those in the organization's financial statements.
5. ***For Labour unions***: Labour unions use financial statements of a Company to gauge how much of a pay increase a Company is able to afford in upcoming labour negotiations.

4.13 Preparation of the Statement of Cash Flows as Per Accounting Std.-3

The cash flow statement is partitioned into three segments, namely: cash flow resulting from operating activities, cash flow resulting from investing activities, and cash flow resulting from financing activities. The money coming into the business is called cash inflow, and money going out from the business is called cash outflow.

- **Operating activities**

Operating activities include the production, sales and delivery of a Company's product as well as collecting payment from its customers. This could include purchasing raw materials, building inventory, advertising, and shipping the product. Operating cash flows include:

- Receipts from the sale of goods or services
- Receipts for the sale of loans, debt or equity instruments in a trading portfolio
- Interest received on loans
- Dividends received on equity securities
- Payments to suppliers for goods and services
- Payments to employees or on behalf of employees
- Interest payments

Items which are added back to [or subtracted from, as appropriate] the net income figure (which is found on the Income Statement) to arrive at cash flows from operations generally include:

- Depreciation (loss of tangible asset value over time)
- Deferred tax

Notes

- Amortization (loss of intangible asset value over time)
- Any gains or losses associated with the sale of a non-current asset, because associated cash flows do not belong in the operating section.(Unrealized gains or losses are also added back from the income statement)

- **Investing Activities**

A Company's investment practices include the acquisition of fixed assets (such as plants and equipment, land and buildings, furniture and fixtures) with a view to producing potential revenues. Owing to being a significant operation, the cash flows from these operations are reported separately. Examples of cash flows arising from investing activities are in AS-3 (revised) as follows:

(a) Cash payments of acquired fixed assets including the intangibles. These payments include those relating to capitalized research and development costs and self-constructed fixed assets;

(b) Cash receipts from disposal of fixed assets including the intangibles

(c) Cash payments to acquire shares, warrants or the debt instruments of other Company's and interests in joint ventures (other than the payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) Cash receipts from the disposition of shares , bonds or debt instruments of other undertakings and joint venture interests (other than receipts from such instruments deemed to be cash equivalents and retained for the purposes of trading or dealing);

(e) Cash advances and loans that are made to third parties. This excludes the advances and loans made by a financial Company);

(f) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial Company);

(g) Cash payments for future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) Cash receipts from future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

- **Financing Activities**

All activities related to the size and composition of the capital (equity and preferences) and borrowing or loans are listed under financial activities. According to the AS-3 (revised), separate disclosure of cash flows resulting from funding activities is relevant as it is useful in predicting potential cash flow statements by fund providers (both capital and borrowings) to the business.

(a) Cash proceeds from issuing of shares or other similar instruments;

(b) Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and

(c) Cash repayments of the borrowed amounts.

Notes

Preparation of Cash Flow Statement

The direct method of preparing a cash flow statement results in a more easily understood report. The indirect method is almost universally used, because most of the accounting standards require a supplementary report similar to the indirect method if a Company chooses to use the direct method.

- **Direct method**

The cash receipts from operating income and cash payments for operating expenses are organized and reported in the cash flow statement by direct process. Gross cash FL due from business activities is the difference between cash receipts and cash payments. It is in essence a profit & loss account on a cash basis.

Another way to determine cash flows under the direct method is to prepare a worksheet for each major line item, and eliminate the effects of accrual basis accounting in order to arrive at the net cash effect for that particular line item for the period. Some examples for the operating activities section include:

Cash receipts from customers:

- Net sales per the income statement.
- Plus beginning balance in accounts receivable.
- Minus ending balance in accounts receivable.
- Equals cash receipts from customers.

Cash payments for inventory:

- Ending inventory
- Minus beginning inventory
- Plus beginning balance in accounts payable to vendors
- Minus ending balance in accounts payable to vendors
- Equals cash payments for inventory

Cash paid to employees:

- Salaries and wages per the income statement
- Plus beginning balance in salaries and wages payable
- Minus ending balance in salaries and wages payable
- Equals cash paid to employees

Cash paid for operating expenses:

- Operating expenses per the income statement
- Minus depreciation expenses
- Plus increase or minus decrease in prepaid expenses
- Plus decrease or minus increase in accrued expenses

Equals

Cash paid for operating expenses Taxes paid:

Notes

- Tax expense per the income statement
- Plus beginning balance in taxes payable
- Minus ending balance in taxes payable

Equals taxes paid

- Interest expense per the income statement
- Plus beginning balance in interest payable
- Minus ending balance in interest payable

Equals interest paid

Under the direct method, for this example, you would then report the following in the cash flows from operating activities section of the cash flow statement:

- Cash receipts from customers
- Cash payments for inventory
- Cash paid to employees λ Cash paid for operating expenses
- Taxes paid
- Interest paid Equals net cash provided by (used in) operating activities

4.14 Interpretation of Cash Flows (Numerical/Illustration)

Sample cash flow using direct method

Cash flows from (used in) operating activities		
Cash receipts from customers	27,500	
Cash paid to suppliers and employees	(20,000)	
Cash generated from operations(sum)	7,500	
Interest paid	(2,000)	
Income taxes paid	(4,000)	
Net cash flows from operating activities		1,5000
Cash flows from (used in) investing activities		
Proceeds from the sale of equipment	7,500	
Proceeds from sale of investment	3,000	
Net cash flows from investing activities		10,5000
Cash flows from (used in) financing activities		
dividends paid	(2,500)	
Net cash flows used in financing activities		(2,500)
Net increase in cash and cash equivalents		9,500
Cash and cash equivalents, beginning of year		1,000
Cash and cash equivalents, end of year		₹10,500

Notes

Example 1:

Following is the Trading and Profit and Loss Account for the year ended 31st March, 2015

Particulars	₹	Particulars	₹
To Purchases	1,27,600	By Sales	1,91,000
To Wages 3	1,900		
To Gross Profit c/d	31,500		
	1,91,000		1,91,000
To Salaries	6,600	By Gross Profit b/d	31,500
To Rent	3,190	By Profit on Sale of Building	
To Depreciation	9,570	(Book Value 40,000)	25,000
To Loss on sale of Investments	3,200		
To Goodwill written off	3,940		
To Net Profit	30,000		
	56,500		**56,500**

Calculate Cash from Operations.

Solution:

Statement showing Cash from Operations

Particulars	₹	₹
Net Profit as per P&L A/c		30,000
Add: Non Cash and Non Operations expenses Depreciation	9,570	
Loss on sale of Investment	3,200	
Goodwill written off	3,940	16,710
		46,710
Less: Non Cash and Non Operating Income Profit on sale Buildings Cash from Operations		 25,000 **21,710**

Example:

Given below are the balance sheets of RK Ltd., as on 31-03-2013 and 31-03-2014

	2013	2014
Liabilities		
Equity share capital	2,00,000	3,00,000
Long term loan	1,00,000	1,00,000
Creditors	1,50,000	2,00,000
Bills payable	2,00,000	3,00,000

Notes

Retained earnings	1,80,000	2,00,000
Assets	**8,30,000**	**11,00,000**
Cash	60,000	30,000
Stock	1,20,000	1,90,000
Debtors	80,000	1,20,000
Goodwill	2,00,000	1,50,000
Plant and machinery	1,00,000	2,00,000
Land and building	2,00,000	4,00,000
Furniture	70,000	10,000
	8,30,000	**11,00,000**

Additional Information:

a) Operating expenses include depreciation ₹ 80,000 and a mortization of Goodwill ₹ 50,000.

b) A machine has been sold for ₹ 15,000. The cost reduce of the machine was ₹ 40,000 and ₹ 20,000 depreciation is charged on the same in 2014.

c) Plant and machinery was purchased for cash ₹ 1,40,000 and land and buildings for ₹ 2,60,000.

d) Furniture was sold for cash ₹ 60,000.

e) Equity shares were issued for cash ₹ 1,00,000.

f) ₹ 80,000 dividend was paid in cash.

g) Net profit for the year ending 31-03-2014 was ₹ 1,00,000.

Prepare statement of cash flow as per As-3 indirect method for the year ending 31-03-2014.

Plant and Machinery Account Notes

	₹		₹
To Balance b/d	1,00,000	By Cash (Sale)	15,000
To Purchase of Machine (B/F)	1,40,000	By Loss on Sale	5,000
		By Depreciation	20,000
		By Balance c/d	2,00,000
	2,40,000		**2,40,000**
Land and Building A/c			
	₹		₹
To Balance b/d	2,00,000	By Depreciation (b/f)	60,000
To Purchase A/c	2,60,000	By Balance c/d	4,00,000
	4,60,000		4,60,000
Furniture A/c			

Notes

	₹		₹
To Balance b/d	70,000	By Cash	60,000
		By Balance c/d	10,000
	70,000		**70,000**

Cash flow Statement for the year ending 31-03-2014

	₹	₹
1) Cash flow from operating activities:		
Net profit for the year after dividend and tax		1,00,000
Add:		
Depreciation (Plant+Building)	80,000	
Loss on sale of plant	5,000	
Goodwill written off	50,000	
Increase in creditors 5	0,000	
Increase in Bills payable	1,00,000	2,85,000
		3,85,000
Increase in Stock	(70,000)	
Increase in Debtors	(40,000)	1,10,000
Net Cash inflows from operations activities		2,75,000
2) Cash flow from investing activities:		
Purchase of plant and Machinery	(1,40,000)	
Purchase of Land Building	(2,60,000)	
Sale of Machinery	15,000	
Sale of Furniture	60,000	
Net Cash outflow from investing activities		(3,25,000)
		(50,000)
3) Cash flow from financial activities		
Issue of equity capital	1,00,000	
Dividend payment	(80,000)	
Net cash flow from financial activities		20,000
Net Decrease in cash		(30,000)
Cash Balance in the beginning		60,000
Cash Balance at the end		30,000

Indirect Method

The net income (loss) is used as the basis in this process and is translated to net cash generated by operating activities. The indirect approach changes net income for things which have had an effect on net income but have not affected cash. Non-cash and non-operating costs on the profit & loss account are applied back to net income, while non-cash and non-operating credits are excluded to measure operating profit before working capital changes.

Notes

Rules of Converting Profit to Cash flow under Indirect Method

The following rules are used to make adjustments for changes in current assets and liabilities, operating items not providing or using cash and non-operating items. The following is an example of how the indirect method would be presented on the cash flow statement:

- Net income per the income statement
- Minus entries to income accounts that do not represent cash flows
- Plus entries to expense accounts that do not represent cash flows
- Equals cash flows before movements in working capital
- Plus or minus the change in working capital, as follows:
    1. An increase in current assets (excluding cash and cash equivalents) would be shown as a negative figure because cash was spent or converted into other current assets, thereby reducing the cash balance.
    2. A decrease in current assets would be shown as a positive figure, because other current assets were converted into cash.
    3. An increase in current liabilities (excluding the short-term debt which would be reported in the financing activities section) would be shown as a positive figure since more liabilities mean that less cash was spent.
    4. A decrease in current liabilities would be shown as a negative figure, because cash was spent in order to reduce liabilities.

4.15 Numericals for Practice

From the following information pertaining to ABC Ltd. Prepare the Trading A/c Profit and Loss A/c for the year ended on 31.3.2018 and a summarised balance sheet as on the date:

Current Ratio	2.5
Quick Ratio	1.3
Proprietary Ratio ($\frac{\text{Fixed Assets}}{\text{Proprietary funds}}$)	0.6
Gross profit Ratio	10%
Debtors Velocity	40 days
Sales	7,30,000
Working Capital	1,20,000
Bank Overdraft	15,000
Share Capital	2,50,000
Closing stock is 10% more than opening stock	
Net profit 10% of proprietary funds.	

Notes

Example 1:

Following is the Balance sheet of J.K Ltd as on 31-3-2011 and 31-3-2012. You are required to prepare the comparative statement and comment on the financial position of the concern.

Liabilities	31/03/2011	31/03/2012	Assets	31/03/2011	31/03/2012
Share capital	1,00,000	1,25,000	Fixed Assets		
Reserves and Surplus	20,000	25,000	Building	75,000	1,50,000
8% Debentures	45,000	30,000	Furniture	2,00,000	2,40,000
Longterm Borrowings	2,00,000	2,50,000	Current Assets		
Creditors	1,25,000	1,50,000	Stock	1,00,000	35,000
Bills Payable	45,000	50,000	Debtors	40,000	1,00,000
Bank Overdraft	12,500	15,000	Cash	1,32,500	1,20,000
	5,47,500	6,45,000		5,47,500	6,45,000

Solution:

Comparative Statement as on 31-3-2011 and 31-3-2012

Particulars	31/3/2011 ₹	31/03/2012 ₹	↑ or ↓ in mount ₹	↑ or ↓ in %
Liabilities:				
a) Share capital	1,00,000	1,25,000	+25,000	+25
Total (a)	1,00,000	1,25,000	+25,000	+25
b) Reserves & Surplus	20,000	25,000	+5,000	+25
Total (b)	20,000	25,000	+5,000	+25
c) Long term Liabilities				
8% Debentures	45,000	30,000	–15,000	-33.333
Long term borrowings	2,00,000	2,50,000	+50,000	+25
Total (c)	2,45,000	2,80,000	+35,000	+14.285
d) Current Liabilites				
Creditors	1,25,000	1,50,000	+25,000	+20
Bills payable	45,000	50,000	–5,000	+11.11
Bank overdraft	12,500	15,000	+2,500	+20
Total (d)	1,82,500	2,15,000	+32,500	+17.80
Total Liabilities (a + b + c + d)	5,47,500	6,45,000	+97,500	+17.80
Assets: **a) Fixed Assets**				
Building	75,000	1,50,000	75,000	100
Furniture	2,00,000	2,40,000	40,000	20
b) Current Assets Total (a)	2,75,000	3,90,000	1,25,000	45.45

Stock	1,00,000	35,000	–65,000	–65
Debtors	40,000	1,00,000	60,000	150
Cash	1,32,500	1,20,000	–12,500	–9.433
Total (b)	2,72,500	2,55,000	–17,500	–6.422
Total (a + b)	5,47,500	6,45,000	97,500	+17.80

Conclusions or Interpretation of the financial statement:

a) There has been overall increase in the Fixed Asset of ₹ 1,10,000, which is financed by the further equity issue and long-term borrowings. It indicates the sound financial policy of the concern.

b) There has been overall decrease in the Current Asset of ₹ 17,500, and increase in Current Liabilities of ₹ 32,500. That means the companies Short-term solvency position is not favorable. It is always ideal to have current ratio of 2:1 i.e., for every rupee of Current liabilities there must be at least two rupee of current asset with the company so that it can meet its immediate financial obligation satisfactory.

c) The reserves and surplus has increased by ₹ 5,000 which indicates good profitability of the concern. Overall, the financial position and profitibility of the company is satisfactory.

Example 2:

Stock turnover is 5 times. Average is ₹ 60,000. Rate of gross profit is 20% on sales. Calculate sales and gross profit.

a) Calculation of Sales

$$\text{Stock turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\therefore\ 5 = \frac{\text{Cost of Goods Sold}}{60{,}000}\ \therefore \text{CGS} = 60{,}000 \times 5,\ \text{CGS} = 3{,}00{,}000$$

Sales = Cost of goods sold + gross profit

(Given % of gross profit is 20% on sales. Therefore % gross profit on cost of goods sold is 25%. i.e., when sales is 100 profit will be 20% on sales i.e., ₹ 20.

Therefore, cost = 100 – 20 = ₹ 80. The % gross profit on cost = $\frac{20}{80}$ x 100 = 25%

$\therefore$ Sales = 3,00,000 + (3,00,000 x $\frac{25}{100}$) = 3,75,000

Example 3:

When current ratio is 2.5, current assets 1,00,000 and quick ratio is 1.5 find out the value of stock and current liabilities.

Solution:

Calculation of current liabilities:

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Notes

$$2.5 = \frac{1,00,000}{\text{Current Liabilities}}$$

$$\therefore \text{ Current Liabilities} = \frac{1,00,000}{2.5} = 40,000$$

Calculation of Stock-in-trade:

Stock = Current asset – Quick asset

$$\text{Quick ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = 1.5 = \frac{\text{Quick Assets}}{40,000}$$

Quick assets = 40,000 x 1.5 = 60,000

Stock = 1,00,000 – 60,000 = ₹ 40,000

Example 4:

Gross profit ratio = 20% on sales; Gross profit ₹ 1,00,000; Cash sales ₹ 1,20,000; Average Debtors ₹ 95,000. Calculate Debtors Turnover Ratio.

$$\text{Gross profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$20 = \frac{1,00,000}{\text{Net Sales}}\ 100$$

20 × Net sales = 1,00,00,000

$$\text{Net Sales} = \frac{1,00,00,000}{20}$$

= 5,00,000

$$\text{Debtors Turnover Ratio} = \frac{\text{Net annual credit sales}}{\text{Average receivables}}$$

Net annval credit Sales = Total Sales – Cash Sales

= 5,00,000 – 1,20,000

= 3,80,000

$$\text{Debtors Turnover Ratio} = \frac{3,80,000}{95,000}$$

= 4 times

Example 5:

From the following compute a) Current ratio, b) Quick ratio, c) Absolute liquid ratio.

Stock–in–trade	1,00,000
Creditors	60,000
Debtors	80,000
Bills payable	10,000

Notes

Cash in hand	40,000
Prepaid expenses	5,000
Bills receivable	45,000

Solution:

a) Calculation of Current Ratio

Current ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current assets = 1,00,000 + 80,000 + 40,000 + 5,000 + 45,000 = 2,70,000

Current liabilities = 60,000 + 10,000 = 70,000

Current Ratio $= \frac{2,70,000}{70,000}$ = 3.86/ Times

b) Calculation of quick ratio

Quick Ratio $= \frac{\text{Quick Assets}}{\text{Current Liabilities}}$

Quick Assets = Current Assets – (Stock + Prepaid expenses)

= 2,70,000 – (1,00,000 + 5,000) = 1,65,000

$\therefore$ Quick Ratio $= \frac{1,65,000}{70,000}$ = 2.35 times.

c) Calculation of Absolute Liquid Ratio

ALR $= \frac{\text{Absolute Assets}}{\text{Current Liabilities}}$

Absolute assets = Quick assets – (Debtors + Bills Receivable)

Quick assets as computed above is ₹ 1,65,000.

Absolute liquid assets = 1,65,000 – (80,000 + 45,000) = ₹ 40,000

ALR $= \frac{40,000}{70,000}$ = 0.57 / Times.

Key Takeaways:

- ***Financial statement analysis:*** It is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account
- ***Profitability ratios:*** Measurement of the firm's profitability in three dimensions namely the sales, investments and on capital employed
- ***Solvency ratios:*** They indicate the ability of the Enterprise to fulfill its long term obligations
- ***Proprietary ratio:*** Expresses the relationship in between the owners' contribution and the total volume of assets.

Notes

- ***Coverage ratios:*** These ratios are calculated to determine the solvency of the firm during the periodical payments of interest and preference dividends.
- ***Turnover ratios:*** Turnover ratios highlight the relationship between the sales and various assets. It indicates the speed which is taken by the firm to convert their assets into sales.
- ***DuPont analysis:*** A fundamental Performance Measurement Method
- ***Cash flow statement:*** Statement providing details about a firm's cash flow operations.

Check your progress:

1. Process of identifying financial strengths and weaknesses of the firm is called:
   a) Accounting Fundamentals
   b) Financial ratio analysis
   c) Computation of balance sheet
   d) Financial statement analysis
2. Ratio between the net profit after tax and the distribution of dividend to preference share holders and the number of equity share holders is called:
   a) Dividend per share
   b) Return on capital
   c) Return on investment
   d) Earning per share
3. DPS ratio is calculated as -
   a) Dividend paid to equity shareholders/ Average number of issued equity shares
   b) Dividend paid to preferance shareholders/ Average number of issued equity shares
   c) Dividend paid to equity shareholders/ Average number of issued preferance shares
   d) Dividend paid to preferance shareholders/ Average number of issued preferance shares
4. Ratios that highlight relationship between the sales and various assets are called:
   a) Profitability ratios
   b) Turnover ratios
   c) Coverage ratios
   d) Solvency ratio
5. Which ratio is also known as the Quick ratio?
   a) Current ratio
   b) Debt turnover ratio
   c) Acid test ratio

Notes

d) Equity ratio

Questions & Exercises

1. What are financial statements? Explain the tools and techniques?
2. Explain the various solvency ratios?
3. What do you understand by DPS and EPS?
4. What is meant by cash flow statement?
5. Classify the activities for the Preparation of Cash Flow statement.

Check your progress

1. d) Financial Statement Analysis
2. d) Earning per share
3. a) Dividend paid to equity shareholders/ Average number of issued equity shares
4. a) Profitability Ratios
5. c) Acid test Ratios

Further Readings

1. Horngren.C.T., *Accounting For Management Control* - An Ntroduction, Englewood Cliffs, Prentice Hall, 1965.
2. Maheswari, S.N., *Management Accounting*, Sultan Chand & Sons, New Delhi.
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Notes

Module - 5: Amalgamation, Absorption and Reconstruction of Companies

Objective

This module is designed to explain the meaning of Amalgamation Absorption and Reconstruction of Companies, how to determine purchase consideration & treatment of amalgamation, absorption, internal and external reconstruction in the books of accounts. It includes the understanding of shares & debentures its types and accounting treatments related to issue of shares and debentures.

Outcome

At the end of this module, learner will be able to-

- Understand the term "Amalgamation" and the methods of accounting for amalgamations.
- Appreciate the concept of Amalgamation Absorption and Reconstruction of Companies
- Appreciate various types of shares and share capital.
- Learn the accounting treatment if shares issued under different circumstances.
- State the meaning and types of debentures;
- Explain the procedure of issue of debentures and its accounting treatment

> ***"Accountancy is the science which deals with recording of monetary transactions of every description".***
>
> According to F.W. Pixley-

1. Corporate Restructuring & Different Forms of Corporate Restructuring

Corporate restructuring is an initiative taken by the corporate body to substantially change its financial structure or its operations. Business restructuring usually happens when a business organization is facing major difficulties and is in financial risk. The restructuring is also applied to ways of raising the scale of the organization and making it small. Corporate restructuring is necessary for removing all financial problems and improving the company's efficiency.

Forms of Corporate Restructuring

a. ***Mergers*** - It is where at least two Company components are merged either by absorption or amalgamation process or by another organisation's framing. Commonly, the merger of at least two business substances is done by trade in protections between the procurement and the objective organization.

b. ***Demergers*** - Under this process of corporate restructuring, at least two organizations are joined into a solitary organization to take advantage of the cooperative energy that emerges from such a merger.

Notes

c. ***Disinvestment:*** When a corporate element sells out or exchanges a benefit or auxiliary, it is known as "divestiture".

d. ***Joint Venture (JV):*** Under this approach, at least two entities frame a substance to support common budgetary activities. The resulting product is called the 'Joint Venture.' All meetings agree to participate to the degree agreed to form another substance and, in turn, share the organization's costs, revenue and power.

e. ***Strategic Alliance:*** Under this method, at least two substances go into the consent to team up with one another, for the accomplishment of certain destinations while as they themselves going about as free associations.

2. Overview of Amalgamation

Amalgamation is defined as the combination of one or more companies into a new entity. It includes:

i. Two or more companies join to form a new company

ii. Absorption or blending of one by the other

Therefore, amalgamation includes absorption.

However, one should remember that Amalgamation as its name suggests, is nothing but two companies becoming one. On the other hand, Absorption is the process in which the one powerful Company takes control over the weaker Company.

Generally, Amalgamation is done between two or more companies engaged in the same line of activity or has some synergy in their operations. Again the companies may also combine for diversification of activities or for expansion of services

Transfer or Company means the Company which is amalgamated into another Company; while Transfer Company means the Company into which the transfer or Company is amalgamated

3. Types of Amalgamation

Amalgamation in the nature of merger:

In this type of amalgamation, not only is the pooling of assets and liabilities is carried out but also of the shareholders' interests and the overall businesses of the Company. In other words, all assets and liabilities of the transferor Company become that of the transfer Company. In this case, the business of the transfer or Company is intended to be carried on after the amalgamation. There are no adjustments intended to be made to the book values. The other conditions that need to be fulfilled include that the shareholders of the vendor Company holding at least 90% of the face value of equity shares become the shareholders' of the vendee Company.

Amalgamation in the nature of purchase:

This method is considered when the conditions for the amalgamation in the nature of merger are not satisfied. Through this method, one Company is acquired by another, and thereby the shareholders' of the Company which is acquired normally do not

Notes

continue to have proportionate share in the equity of the combined Company or the business of the Company which is acquired is generally not intended to be continued.

If the purchase consideration exceeds the net assets value then the excess amount is recorded as the goodwill, while if it is less than the net assets value it is recorded as the capital reserves.

Example:

Following are the abridged Balance Sheets of Ding Company Limited and Dong Company Limited as on 31st March, 2019:

Liabilities	Ding Co. (₹)	Dong Co. (₹)	Assets	Ding Co. (₹)	Dong Co. (₹)
Share Capital:			Fixed Assets	6,60,000	2,83,800
Faculty Share Capital			Current Assets	2,40,000	1,18,200
(₹ 10 each)	4,80,000	1,80,000			
12% Preference Share					
Capital (₹ 100 each)	-	60,000			
General Reserve	2,76,600	58,800			
Statutory Reserve	23,400	7,500			
Profit and Loss A/c	33,780	21,300			
13% Debentures	-	15,000			
Current Liabilities	86,220	59,400			
	9,00,000	4,02,000		9,00,000	4,02,000

On 1st April, 2011 Ding Limited takes over Dong Limited on the following terms:

(a) Ding Limited will issue 21,000 shares of ` 10 each at per to the equity shareholders of Dong Ltd.

(b) Ding Ltd. will issue 660 12% Preference shares of ` 100 each at par to the preference Shareholders of Dong Ltd.

(c) The debentures of Dong Ltd. will be converted into equal no. of 14% debentures of the same denomination.

You are informed that the statutory reserves of the Dong Ltd. are to be maintained for two more years. You are required to show the Balance Sheet of Ding Ltd. immediately after the scheme of the amalgamation has been implemented assuming that:

(a) The amalgamation is in the nature of merger and

(b) The amalgamation is in the nature of purchase.

Solution -

(a) When amalgamation is in the nature of merger:

Calculation of General Reserve:

Notes

Purchase Consideration (21,000 equity shares of ₹ 10 each) + 660 preference shares of ₹ 100 each		
Less: Share Capital of Dong Ltd.		
Equity Capital	1,80,000	
Pref. Capital	60,000	2,40,000
Excess of Consideration		36,000

Excess of Consideration will be subtracted from the general reserve of Dong. Ltd.

General Reserve	58,800
-Excess of Consideration	36,000
	22,800
+ General Reserve of Ding Ltd.	2,76,600
	2,99,400

Balance Sheet of Ding Limited as on 31st March, 2019

Liabilities	(₹)	Assets	(₹)
Share Capital:		Fixed Assets	9,43,800
Equity capital (Shares of ₹10 each)	6,90,000	Investments	-
10% Preferences capital (Shares of ₹ 100 each)	66,000	Current Assets, Loans and Advances	
Reserve & Surplus:		Current Assets	3,58,200
General Reserve (calculated above)	2,99,400	Loans & Advances	-
Statutory Reserve	30,900	Miscellaneous Expenditures	-
Profit and Loss A/c	55,080		
Secured Loans			
13% Debentures	15,000		
Unsecured Loans:	-		
Current Liabilities and Provisions			
(a) Current Liabilities	1,45,620		
(b) Provisions	-		
	13,02,000		**13,02,000**

(b) When amalgamation is in the nature of purchase:

Calculation of Goodwill or Capital Reserve on Amalgamation:

	₹
Fixed Assets of Dong Ltd.	2,83,800
+Current Assets of Dong Ltd.	1,18,200
Total of Assets	4,02,000

Notes

Less: External Liabilities		
13% Debentures	15,000	
Pref. Capital	60,000	
Current Liabilities	59,400	74,400
Net Assets of Dong Ltd.		3,27,600
-Purchase Consideration (₹ 2,10,000 + ₹ 66,000)		2,76,000
Capital reserve		51,600

Balance Sheet of Dong Limited as on 31st March, 2019

Liabilities	(₹)	Assets	(₹)
Share Capital:		Fixed Assets	9,43,800
Equity capital (Shares of ₹10 each)	6,90,000	Investments	-
12% Preferences capital (Shares of ₹ 100 each)	66,000	Current Assets	3,58,200
Reserve & Surplus:			
Capital Reserve	51,600	Amalgamation Adjustment	-
General Reserve	2,76,600	Account	7,500
Statutory Reserve	30,900		
Profit & Loss A/c	33,780		
Secured Loans:			
13% Debentures	15,000		
Current Liabilities and Provisions			
Current Liabilities & Provision:			
Current Liabilities	1,45,620		
	13,09,500		**13,09,500**

4. Purchase Consideration

Purchase consideration is the agreed amount to be paid by the transferor firm which is the Vendor firm in return for the transferor Company's ownership. This can be in cash, shares or any other assets decided between the two companies.

- ***Net Assets Method***

Net Assets method is used when the Company calculates the value of shares based on the assets of the Company. And to calculate Purchase consideration value by Net Assets method is Net Assets available for equity shareholders divided by the number of equity shares.

To get net assets value you need to subtract the value of the assets from third-party liabilities from total assets value including preference share capital and other liabilities. Then the output value is net assets which are divided by the number of equity shareholders.

Notes

Example:

X Company Limited takes over the business of Y Company Limited on 31st December 2010. The Balance Sheet of Y Limited on this date was as follows:

Balance Sheet of Y Limited as on 31st December, 2018

Liabilities	(₹)	Assets	(₹)
Share Capital:		Goodwill	1,40,000
30,000 Equity capital (Shares of ₹10 each)	3,00,000	Land & Buildings	80,000
		Plant & Machinery	1,40,000
10% debentures	50,000	Stock	80,000
Sundry Creditors	30,000	Debtors	40,000
General Reserve	20,000	Cash Balance	10,000
Profits & Loss A/c	1,00,000	Preliminary Expenses.	10,000
	5,00,000		5,00,000

On the basis of above Balance Sheet of Y Company Limited, calculate the purchase consideration assuming:

(a) The values agreed for various assets are: Goodwill ₹ 1,10,000, Land & Buildings ₹ 1,25,000, Plant and Machinery ₹ 1,20,000, Stock ₹ 65,000 and Debtors ₹ 40,000.

(b) X Company Limited does not take over cash but agrees to assume the liability of sundry creditors at ₹ 25,000.

Solution:

Agreed value of various assets	₹
Goodwill	1,10,000
Land & Buildings	1,25,000
Plant & Machinery	1,20,000
Stock	65,000
Debtors	40,000
Total of Assets	4,60,000
Less: External liabilities Sundry Creditors taken by X Ltd.	25,000
Purchase Consideration	4,35,000

- ***Net Payment Method***

In the Net Payment Method calculation of Purchase consideration, all the focus is on the profit of shareholders and the amount they are getting after the Amalgamation of the Company.

Here the Company which takes over every other Company has to pay the consideration value of the transaction to the shareholders in equity and liability. For example, the new Company decided to provide the current shareholder of the old Company with some additional benefit as well as hard cash, etc. or premium stock for their Company shares.

Notes

Example:

ABC Company Limited agrees to take over the business of XYZ Company Limited, the consideration being the assumption of trade liabilities ` 62,500, the payment of the cost of liquidation ` 2,500, the redemption of the 'Y' Debentures of ` 2,50,000 at a premium of 10%, the discharge of 'X' Debentures of ` 5,00,000 at a premium of 8% by the issue of 10% Debentures in the Tom Company Limited and the payment of ` 10 per share in cash and exchange of 2 fully paid ` 10 in Tom Co. Ltd., at the market price of ` 15 per share for every share in the XYZ Co Ltd. The share capital of XYZ Company Ltd. consists of 25,000 shares of ` 25 each fully paid.

Solution:

Calculation of Purchase Consideration

1.	Payments in cash for cost of Liquidation	2,500
2.	Payment in cash for redemption of 'Y' type Debentures	
	(2,50,000 + 25,000)	2,75,000
3.	Payment to 'X' type Debentures (New Debentures)	5,40,000
4.	Payment to Shareholders:	
	in cash (25,000×10)	2,50,000
	in shares (25,000×2×15)	7,50,000
	Total Purchase Price	18,17,500

- ***Intrinsic Value Method***

According to this method, net asset value is calculated by net asset method and is divided by the value of one share of the transfer Company which gives the total number of shares to be received from the transfer Company by the transfer shareholders or Company. When the number of shares to be received by the transferor Company is already determined then it is divided by the existing shares of the transferor Company and thus the ratio of shares can be found out.

Following are the Balance Sheets of Aakash Ltd. and Gagan Ltd. as on 31st March, 2019:

Liabilities	Aakash Ltd. (₹)	Gagan Ltd. (₹)	Assets	Aakash Ltd. (₹)	Gagan Ltd. (₹)
Share Capital:			Fixed Assets	6,60,000	2,83,800
Share Capital (₹ 10 each)	4,50,000	3,60,000	At Cost less dep.	4,20,000	2,25,000
Reserves	2,85,000	30,000	Current Assets;		
Secured Loans:			Stock	1,26,000	1,41,000
10% Debentures	-	60,000	Trade Debetors	90,000	1,50,000
Current Liabilities:			Bank balance	2,40,000	30,000
Sundry Creditors	1,41,000	96,000			
	8,76,000	5,46,000		8,76,000	5,46,000

Notes

Aakash Ltd. agreed to absorb to Gagan Ltd., as on 31st March, 2011 on the following terms:

(a) Aakash Ltd. agreed to repay 10% debentures of Gagan Ltd.

(b) Aakash Ltd. agreed to revalue its fixed assets at ₹ 5, 85,000 to be incorporated in the books.

(c) Shares of both the companies, to be valued on net assets basis after considering ₹ 1, 50,000 towards value of goodwill of Gagan Ltd.

(d) The cost of absorption of 9,000 is met by Aakash Ltd.

You are required to calculate the net assets and ratios of exchange of shares.

Solution -

Calculation of Net Assets

Particulars		Aakash Ltd. ₹	Gagan Ltd. ₹
Goodwill	-	-	1,50,000
Fixed Assets		5,85,000	2,25,000
Stock		1,26,000	1,41,000
trade Debtors		90,000	1,50,000
Bank Balance		2,40,000	30,000
Total of assets		10,41,000	6,96,000
Less: External Liabilities:			
10% Debentures	60,000	-	-
Sundry Creditors	96,000	1,41,000	1,56,000
Net Assets		90,00,000	5,40,000
Intrinsic worth of a share		9,00,000	5,40,000
		45,000	36,000
		= ₹ 20	= ₹ 15

On the basis of above calculation, it can be analysed that four shares of Aakash Ltd., be equal to three shares of Gagan Ltd. Thus, the exchange ratio will be 3 : 4.

- ***Lump Sum Method***

The purchasing firm can decide to pay the vendor Company a lump-sum due to the purchase of its business. This approach in fact is not based on any scientific ideas and techniques. This approach is an unscientific and non-mathematical method for determining the importance of transactions.

Numerical on Purchase Consideration

Purchase Consideration using net asset method: Total of assets taken over and this should be at fair values minus liabilities that are taken over at the agreed amounts.

Notes

Particulars	Rs.
Agreed value of assets taken over	XXX
Less: Agreed value of liabilities taken over	XXX
Purchase Consideration	XXX

Agreed value means the amount at which the transfer or Company has agreed to sell and the transferee Company has agreed to take over a particular asset or liability.

Purchase consideration using payments method: Total of consideration paid to both equity and preference shareholders in various forms.

Example: A. Ltd takes over B. Ltd and for that it agreed to pay Rs 5,00,000 in cash. 4,00,000 equity shares of Rs 10 each fully paid up at an agreed value of Rs 15 per share. The Purchase consideration will be calculated as follows:

Particulars	Rs.
Cash	5,00,000
4,00,000 equity shares of Rs10 fully paid up at Rs15 per share	60,00,000
Purchase Consideration	65,00,000

5. Methods of Accounting for Amalgamation

- ***Pooling of Interests Method***

Through this accounting method, the assets, liabilities and reserves of the transfer or Company are recorded by the transferee Company at their existing carrying amounts.

- ***Purchase Method***

In this method, the transfer Company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual assets and liabilities of the transfer or Company on the basis of their fair values at the date of amalgamation.

6. Internal and External Reconstruction

It is an arrangement made by the companies whereby the claims of shareholders, debenture holders, creditors and other liabilities are altered/ reduced, so that the accumulated loss are written off, asset are valued at its fair. Internal reconstruction is a method of corporate restructuring where an arrangement is made by the Company of the organization where in changes in the assets and liabilities are made to improve the financial position without liquidating the Company or transferring the ownership to external party.

Whereas external reconstruction is the one where an existing company is liquidated and taken over by another newly formed Company and the transfer of assets and liabilities takes place and the same is considered similar to amalgamation.

Notes

7. Difference Between Internal and External Reconstruction

Basis	Internal	External
Meaning	IR is a restructuring method that doesn't create a new Company via liquidation.	ER is a restructuring method that creates a new Company via liquidation
Application	It is done to ensure an inner re-arrangement of financial structure	It is done to form a new Company.
Approval of court	Required.	Not Required.
Liquidation	Liquidation isn't done.	Liquidation is done.
Existence	No new existence is formed.	A new Company is formed.
Process	Very slow, tedious, and takes a long time.	Quick and swift, doesn't take much time
Losses against profits	It can set off past losses against future profits.	Since a new Company is established losses of the old Company can't be set off against the profits of the new Company.

8. What is Company Absorption?

Absorption is a form of merger in which two or more companies are combined into an 'existing business.' In the absorption scenario, only one corporation can 'survive' and the others can lose their name. Generally a business that survives purchasing the other companies (buyer), when an acquired company (a seller) ceased to be. Acquired business passes its cash, liabilities and equity to the acquiring firm. Therefore, the Company that absorbs acquires all of the client's rights and responsibilities that are picked up.

There are so many reasons for company absorption. One of them is that it won't be having the credibility on the market as the old one due to the existence of the new Company. So, that's why buying business buys an established Company to take advantage of its power to leverage the market opportunities that exist.

Features of Absorption

The features of absorption are –

- One or more companies are liquidated.
- No new Company is formed.
- The nature of business of both companies is similar.
- Generally, larger Company purchases the business of smaller Company.

Objectives of Absorption

These are as follows:

(1) To eliminate or reduce cut-throat competition.

Notes

(2) To reap the economies of the production of goods and services on a large scale.

(3) To gain control over the market.

(4) To gain the benefits of the service of the experts.

(5) To promote research and development schemes.

(6) To derive the other advantage of the amalgamation.

10. Methods of Internal Reconstruction-part-1

The term a business reconstruction means a reorganization of the Company's financial structure. This is separate from absorption and amalgamation. In the case of heavy losses, over capitalization or numerous financial issues, a Company's restructuring is implemented to eliminate these shortcomings and reorganize the financial structure.

Internal reconstruction is the reorganization of the capital structure of a Company without the formation of a new Company and without liquidating the existing Company. in the internal reconstruction, the following two are included: (a) Alteration of share capital (b) Reduction of share capital

a. Alteration of the Share Capital

According to Section 94 of the Companies Act, a limited Company that has a share capital may, if so authorized by its Articles of Association, alter the capital clause of its Memorandum of Association by the ordinary resolution in the general meeting. These alterations do not require the approval of the Company Law Board. Alteration in the capital clause may be in any of the following ways:

- Consolidation of all or a part of the Company's existing shares of smaller denomination into shares of a larger denomination.
- A share capital increase by the issue of fresh shares of such an amount which it thinks as expedient.
- Conversion of all or a part of its fully paid up shares into stock and vice-versa.
- Sub-division of its shares or a part of them of larger denominations into smaller denominations.
- Cancellation of those shares that have not been issued yet.
- Reduction of share capital

A Company's capital reduction is subject solely to the legal provisions of Section 100 to 105 of the Companies Act, 1956. If the Company is approved by its Articles of Association, it may reduce its share capital by the following means, by a special resolution and upon approval by the court upon petition:

- Reducing or extinguishing the liability of shareholders in respect of share capital not paid up.
- Writing off or cancelling any paid up capital which is lost by available assets.
- Paying off paid up capital in excess of the requirements of the Company.

- Any other method approved by the court.

As per Section 100, reduction (b) and (c) may be made either in addition to or without extinguishing or reducing the liability of shareholders for uncalled capital.

Any capital reduction is risky to creditors, since a Company's issued capital represents the protection on which the creditors depend. Organizations usually do not name the whole value of the stock at one time. The uncalled capital serves as a potential protection for the Company's creditors. The court shall set up a list of creditors for this reason, and hear their objections, if any, and being satisfied that either the creditors agree to the reduction or that the Company has discharged or secured their debts, may accept the reduction on any terms it considers reasonable.

11. Inter Company Holdings

Inter-Company holdings apply to transferee investments in the transferee group. It is this that is necessary to remember when filing financial statements. Calculation of net assets arising from investments as the valuation of investments is dependent on certain interest of the business.

In India, it is not permissible for a Company to purchase shares in its holding. Nevertheless, if the subsidiary had purchased shares in the holding Company before it became the subsidiary or before the 1956 Companies Act began, the Company may continue to hold the shares [section 42(3)].

However, the subsidiary Company will not be able to exercise any voting rights at the meetings of the members of the holding Company. At the point of view of the accounts, the income attributed to the subsidiary would have to be measured taking into account the fact that it will still have a right to the benefit of the holding Company, which will in effect claim its share of the subsidiary 's profits.

Before preparing the financial statements it should be noted that –

- The calculation of net worth assets without investments as the value of investments are based on other Company share value
- While calculating purchase consideration we need to deduct the value of share holdings in transferee Company (a take-off)

Key takeaways:

- ***Acquisition Financing:*** The type of funding obtained by a business for the purpose of purchasing another business.
- ***Acquisition Planning***: Coordination of the activities of the personnel involved in the purchase of an asset or supply to ensure its timely and cost effective acquisition.
- ***Customer Acquisition***: The process of persuading a consumer to purchase a company's goods or services.
- ***Debts***: An amount of money borrowed by one party from another.
- ***Employee***: A person who is hired to work for another or for a business, firm, etc., in return for payment.

Notes

- ***Absorption***: It is a form of merger in which two or more companies are combined into a 'existing business
- ***Goodwill:*** An account that can be found in the assets portion of a company's balance sheet.
- ***Single Acquisition***: It refers to one company buying the assets and operations of another company and absorbing what is needed while simply discarding duplicated or unnecessary pieces of the acquired business.
- ***Corporate Restructuring***: It is an initiative taken by the corporate body to substantially change its financial structure or its operations.

Check your progress:

1. ______________ is an initiative taken by the corporate body to substantially change its financial structure or its operations.
   a) Corporate Assessment
   b) Corporate Restructuring
   c) Amalgamation
   d) Merging
2. When a corporate element sells out or exchanges a benefit or auxiliary, it is known as
   a) Demerger
   b) Corporate Restructuring
   c) Merger
   d) Disinvestment
3. Two substances go into the consent to team up with one another in
   a) Strategic Alliance
   b) Corporate Restructuring
   c) Merger
   d) Disinvestment
4. For an amalgamation the vendor company holding must be _________
   a) 65%
   b) 85%
   c) 90%
   d) 100%
5. ____________________ is used when the Company calculates the value of shares based on the assets of the Company
   a) Net assets method
   b) Current ratio

Notes

c) Net payment method

d) Liquidity ratio

Questions & Exercises

1. Differentiate between Internal and External Reconstruction
2. What do you understand by amalgamation? What are the methods of amalgamation?
3. What is company absorption.
4. What do you understand by net asset method.
5. Define Intercompany holdings

Check your progress:

1. b) Corporate Restructuring
2. d) Disinvestment
3. a) Strategic Alliance
4. c) 90%
5. a) Net assets method

Notes

Company Accounts

"A company is a person, artificial, invisible, intangible, and existing only in the contemplation of the law.

According to the Companies Act, 1956-

1 Company and Its Features

Section 2(20) of the 2013 Act defines the term Company to mean a Company incorporated under the companies act 2103 or any previous Company law. These may be -

- Companies limited by shares,
- Companies limited by guarantee and
- Unlimited companies.

Features of a Company

- ***Corporate Body:*** A Company needs to be registered under the Companies Act, 2013. Any other organisation incorporated with the Registrar of Companies, and subsequently not registered cannot be considered as a Company.
- ***Separate Legal Entity***: A Company exists as a separate legal entity which is different from its shareholders and members. Due to this feature, shareholders can enter into a contract with the Company and can also sue the Company and be sued by the Company.
- ***Limited Liability:*** As the Company exists as a separate entity, members of the Company are not liable for the debts of the Company. Liability of members of a Company is limited to the extent of the shares that are held by them or by the extent of the guarantee amount
- ***Transferability of Shares:*** Shareholders of a public limited Company can transfer their shares as per the rules laid down in the articles of association. However, in case of a private limited Company, there might be some restrictions on the transfer of shares.
- ***Common Seal***: The firm is an artificial entity or a person, and therefore cannot sign its name by itself. It creates the necessity of a common seal that can be used for representing the decisions made on behalf of the Company.
- ***Perpetual Succession***: The Company being an artificial person established by law perpetuates to exist regardless of the differences in its membership. In simple words, a Company is an artificial person. Therefore, it does not have any restrictions on age. The factors like death, insolvency, retirement or the insanity of one or all of the members do not impact the Company status.
- ***Number of Members***: As per the Companies Act, 2013, the minimum number of members required to start a public limited Company is seven while for a private limited Company, it is two. The maximum number of members for a public limited Company can be unlimited while it is restricted to 200 for a private limited Company.

Notes

2 Types of Companies

Types of companies are based on the characteristics, ownership, liability, and the Company act of various countries.

A. Types of companies based on the number of members
   1. Public limited company
   2. Private limited company
   3. One person company

B. Types of companies based on the liability of the members
   1. Companies limited by shares
   2. Companies limited by guarantee
   3. Unlimited company

Types of Companies Based on the Number of Members

Based on the number of members/shareholders of the Company, three types of companies are (1) public limited Company, (2) private limited Company, and (3) one-person Company.

Public Limited Company

Public limited companies are listed on the stock exchange where it's share or the stocks are traded publicly.

A public limited Company;

- Must have a minimum number of members which is mandatory by the Company law,
- It can have an unlimited number of members,
- Operates as a separate legal entity from its owners,
- Stocks are traded publicly,
- Publishing the complete and true financial position of the Company is required by law so that investors can determine the true worth of its stock (shares),
- Has limited liability, which is by shareholders share.
- Shareholders of a public limited Company are limited to potentially lose only the amount they have paid for the shares they own.

A public limited Company called "Plc" commonly in the UK and "Inc." is used in the United States.

Private Limited Company

A private Company has a separate legal entity, owned entirely by a relatively small group of individuals or groups (minimum 2), and shares cannot be publicly traded in stock markets.

A private limited Company;

- Has separate legal entity from its owners,

Notes

- Does not require to publish the Company's financial positions,
- Must have a minimum of 2 members and a maximum number of members (usually 50) that is defined in the country's Company law,
- Has a limited liability,
- Faces fewer regulations and government oversight than a public limited Company.

Companies can go from private to public, by selling shares to the public, often as a way to raise a large amount of money. In reverse, public companies can be taken private if, for example, a majority owner wants to consolidate control.

One Person Company

A member may hold virtually the entire share capital of a Company. Such a Company is known as a "one-person Company". This can happen both in a private Company and a public Company.

The other member/members of the Company may be holding just one share each. Such other members may be just dummies to fulfill the requirements of the law as regards minimum.

Types of Companies Based on the Liability of the Members

Based on the liability type and limit of the members/shareholders of the Company; 3 types of companies are

(1) Companies limited by shares,

(2) Companies limited by guarantee, and

(3) Unlimited Company.

- **Companies Limited by Shares**

  A Company limited by shares is a registered Company having the liability of its member limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them.

  A shareholder cannot be called upon to pay more than the amount remaining unpaid on his shares. Shareholder's assets cannot be called upon for the payment of the liabilities of the Company if nothing remains to be paid on the shares purchased by him. Such a Company is also known as a "Share Company."

- **Companies Limited by Guarantee**

  A Company limited by guarantee is one having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the Company in the event of its being wound up. Such a Company is also known as a "Guarantee Company". A pure "guarantee Company" does not have a share capital.

- **Unlimited Company**

  An unlimited Company is where the liability of the members or shareholders is not limited. An unlimited Company;

Notes

- Incorporated with or without a share capital (and similar to its limited Company counterpart), but where the legal liability of the members or shareholders is not limited:
- That is, its members or shareholders have a joint, several and non-limited obligations to meet any insufficiency in the assets of the Company to enable settlement of any outstanding financial liability in the event of the Company's formal liquidation.

3 Share Capital- Definition and Categories

It means the capital of a Company, or the figure in terms of so many rupees divided into shares of a fixed amount, or the money raised by the issue of shares by a Company. A public Company and its subsidiary can issue only two kinds of shares, viz., preference and equity. Therefore, such a Company can have only two kinds of share capital by issue of preference shares and equity shares, viz., preference share capital and equity share capital. The expression "Preference Share Capital" and "Equity Share Capital" are used in the following five different senses:

1. ***Nominal, Authorised or Registered Capital:*** This is the sum stated in the memorandum as the share capital of a Company, with which it is proposed to be registered. This is the maximum amount of capital which it is authorised to raise, by issuing shares and upon which it pays stamp duty. As we shall see later, when the original amount of the authorised capital is exhausted by issue of shares, it can be increased by passing an ordinary resolution.
2. ***Issued Capital:*** It is that part of the authorised capital which, the Company has issued for subscription. The amount of issued capital is either equal to or less than the authorised capital.
3. ***Subscribed Capital***: It is that portion of the issued capital which has been subscribed for by the purchasers of the Company's shares. The amount of subscribed capital is either equal to or less than the issued capital.
4. ***Called-up Capital:*** The Company may not call up full amount of the face value of the shares. Thus, the called-up capital represents the total amount called-up on the shares subscribed. The total amount of called-up capital can be either equal to or less than the subscribed capital.

Alteration of Share Capital

Section 94 provides that if the articles authorise, a Company limited by share capital may, by an ordinary resolution passed in general meeting, alter the conditions of its memorandum in regard to capital so as:

1. To increase its authorised share capital by such an amount as it thinks expedient by issuing fresh shares;
2. To consolidate and divide all or any of its shares into shares of larger amount than its existing shares;
3. To convert all or any of its fully paid-up shares into stock and reconvert the stock nto fully paid-up shares of any denomination;

Notes

4. To sub-divide its shares, or any of them, into shares of smaller amount than fixed by the memorandum, but the proportion paid and unpaid on each share must remain the same;
5. To cancel shares which, at the date of the passing of the resolution in this behalf, have not been taken or agreed to be taken by any person.

4 Introduction to Shares & Characteristics

A share in the share capital of the Company, including stock, is the definition of the term 'Share'. This is in accordance with Section 2(84) of the Companies Act, 2013. In other words, a share is a measure of the interest in the Company's assets held by a shareholder.

A share or the proportion of interest of a shareholder is equal to the proportion of the amount paid to the total capital payable to the Company.

Characteristics of Shares

- ***Ownership rights***

  When you buy a share, you are buying a piece of that Company – you become its part owner. That ownership gives you certain rights, including voting on important matters of the Company and participating in the profits.

- ***High profit potential***

  When you buy stocks, you become the owner to that extent and when the Company makes more and more profits and expands, the demand for its shares will also rise. As a result, the share prices also move up. As an owner, you already have rights in its profits. Now, as the demand for the shares goes up, a second benefit in the form from of appreciation in capital invested opens up.

  For example: Many of the early employees of Infosys are millionaires because their stock has gone up dramatically.

- ***Risk***

  However what if the company did not make profits as expected? There won't be much demand for its shares nor will it carry a high rate of profit share. Hence, along with the potential for extraordinary gain comes the potential for high loss. These two go hand in hand. If you are not careful in choosing a Company, you can lose money by investing in stocks. Not only in stocks, in fact, have even the safest savings deposits carried unseen risks. When your account for inflation and taxes, you'll find that most of the so called risk free investments are not so safe.

- ***Source of Income***

  We have already explained that. Since shareholders are part owners of the Company, they are entitled to get a part of the annual profits of the Company. Shareholders get income by way of dividends and bonus shares.

5 Types of Shares

1. ***Ordinary shares*** are the most common type of shares and are standard shares with no special rights or restrictions. They have the potential to give the highest financial

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gains, but also have the highest risk. Ordinary shareholders are entitled to voting rights; however, they are the last to be paid if the Company is wound up.

2. ***Non-voting ordinary shares*** carry the same conditions as ordinary shares except with regards to voting rights. Shareholders may have voting rights under certain circumstances or they may have no voting rights at all.

3. ***Preference shares*** typically carry a right that gives the holder preferential treatment when annual dividends are distributed to shareholders. Shares in this category receive a fixed dividend, which means that a shareholder would not benefit from an increase in the business' profits. However, usually they have rights to their dividend ahead of ordinary shareholders if the business is in trouble. Preference shares carry no voting rights.

4. ***Cumulative preference shares*** give holders the right that, if a dividend cannot be paid one year, it will be carried forward to successive years. Dividends on cumulative preference shares must be paid, despite the earning levels of the business, provided the Company has profits that can be distributed.

5. ***Redeemable shares*** come with an agreement that the Company can buy them back at a future date - this can be at a fixed date or at the choice of the business. A Company cannot issue only redeemable shares, so they must ensure that they also issue non-redeemable shares.

6 Issue of Shares for Cash

Joint stock companies carry a wide scale of their business. Such businesses therefore need huge amounts of money. By issuing shares and debentures to the public, they fulfill their demand. Additionally, they may sell shares to the public under various methods after obtaining the certificate of incorporation.

A corporation mostly gives shareholdings to the general public. The business can even go for preferential shares if the capital generated by ordinary shares isn't enough. Whether by collecting the full market value of shares at the time of issue or by collecting the face value in separate calls, they may issue this. It covers application, allotment, first call etc.

- **Issue of shares at par**

Par value is the value given or mentioned on the certificate of share. Each Company can mention its own par value like Rs.10, Rs.20, etc. When the Company asks the total par value of at the time of application; it is called the issue of shares on a lump sum basis.

E.g., if a share of Rs.20 is issued at Rs.20 and the whole amount is collected with the application, it is called the issue of share at par on a lump sum basis. The following entries are made for issuing shares.

- ***Issue of shares at premium***

When a share is sold at a price that is more than the par value, the share issue at a premium is named. For example, if a share of Rs.10 is issued t Rs. 12, then the share issue at a premium is called that. Here Rs 2 is the value of the premium per share.

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Accounting Treatment

On application: the amount of money paid with various installments represents the contribution to share capital and should ultimately be credited to share capital. however, for the sake of convenience, initially individual accounts are opened for each installment. All money received long with application is deposited with a scheduled bank in a separate account opened for the purpose.

The journal entry is as follows:

Bank A/c Dr.

To Share Application A.c

(amount received on application for – shars @ Rs. _________ per share)

On allotment: When minimum subscription has been received and certain legal formalities on the allotment of shares have been duly compiled with, the directors of the company proceed to make the allotment of shares.

The allotment of shares implies a contract between the company and the applicants who now become the allottees and assume the status of shareholders or members.

The journal entries with regard to allotment of shares are as follows:

1. For transfer of Application Money

   Share Application A/c Dr.

   To Share Capital A/c

   (Application money on ____________ Shares allotted/transferred to share capital)

2. For Money Refunded on Rejected application

   Share Application A/c Dr.

   To Bank A/C

   (Application money on returned on rejected application for ___________shares)

3. For Amount Due on Allotment

   Share Allotment A/c Dr.

   To Share Capital A/c

4. For Adjustment of Excess application Money

   Share Application A/c Dr.

   To Share Allotment A/c

   (Application Money on _________ Shares @ ₹__________ per shares adjusted to the amount due on allotment).

5. For Receipt of Allotment Money

   Bank A/c Dr.

   To Share Allotment A/c

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(Allotment money received on ____________ Shares @ ₹ ___________ per share Combined Account)

Note:- The journal entries (2) and (4) can also be combined as follows:
Share Application A/c
To Share Allotment A/c
to Bank A/c
(Excess application money adjusted to share allotment and balance refunded)

7 Subscription of Shares

A kind of share that investors can turn at a fixed price at some point in the future into new ordinary shares in the Company is known as subscription of shares. These may not have the same rights as ordinary shares (e.g., before being converted into ordinary shares, these may not be entitled to any dividends).

Shares which have the right (but not the obligation) to be exchanged for a Company's common stock (ordinary shares) at a fixed price and within a defined duration, while at the same time having the right to a dividend before the exchange.

A Company issues shares to the general public for subscription. It receives the applications along with the application money for the allotment of shares to the applicants. It may hardly happen that it receives the applications equal to the number of shares issued. Thus, there may be either under subscription or oversubscription.

- ***Under Subscription of shares***

  A Company offers shares to the public inviting applications for their subscription. When the number of shares applied for by the public is less than the number of shares issued by the Company, it is a situation of under-subscription.

  Generally, a Company that is newly set up or does not have a good reputation in the market receives under-subscription. Usually, such companies opt for underwriting of the shares. However, if an Company receiving under-subscription receives the minimum subscription, it can allot the shares for which it receives the application.

- ***Oversubscription of shares***

  When a Company receives applications for shares more than the number of shares it has offered to the public, it is known as over-subscription of shares. Usually, the companies with strong financial background or good reputation in the market or profitable future prospects receive over-subscription of shares.

  According to the guidelines of SEBI, a Company cannot out-rightly reject any application. However, it can do so where the information is incomplete, the signature is not there or the application money is insufficient.

8 Share Issued at Discount & at Premium

- ***Issue of share at discount***

  The issue of shares at a discount means the issue of the shares at a price less than the face value of the share. For example, if a Company issues share of Rs.100 at Rs.85, then Rs.10 (i.e. Rs 100 - 85) is the amount of discount. It is nothing but a loss to the Company. One must remember that the issue of share below the Market Price

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(MP) but above the Face Value (FV) is not termed as 'Issue of Share at Discount'. The issue of Share at Discount is always below the Nominal Value (NV) of the shares. The Company debits it to a separate account called 'Discount on Issue of Share' Account.

Conditions for Issue of Shares at Discount

1. In order to issue the shares at a price less than the face value, the Company has to get permission from the relevant authority. For seeking permission, they should call and upon a general meeting and discuss and authorize the matter in that meeting.
2. There is a cap on the rate of discount. A company cannot issue any shares at more than 10% discount.
3. The Company should issue the shares within 60 days of receiving permission from the relevant authority. In certain cases, the company can extend this time frame after getting permission in the permission.
4. The Company cannot issue these shares before passing of 1 year from the date of commencement of business.
5. The shares must belong to the same class of shares which are already available in the market. For example, if the has previously issued Equity shares then this time also, the Company has to issue Equity shares only.
6. Also, the Company has to acquire the sanction by the Central Government after getting approval from the general meeting.

- ***Issue of Shares at Premium***

  The issue of shares at premium refers to the issue of shares at a price higher than the face value of the share. In other words, the premium is the amount over and above the face value of a share.

  Usually, the companies that are financially strong, well- managed and have a good reputation in the market issue their shares at a premium. For example, if a Company issues a share of nominal or face value of ₹10 at ₹11, it issues it at 10% premium.

  A Company may call the amount of premium from the applicants or shareholders at any stage, i.e. at the time of application, allotment or calls. However, a company generally calls the amount of Premium at the time of allotment.

Accounting treatment of Securities Premium

The company needs to credit the amount of Premium in a separate account i.e. Securities Premium A/c, as it is not a part of the Share Capital. It is actually a gain for the Company. As per the Companies Act, 2013 the Company shows the credit balance of the Securities Premium A/c under the heading 'Reserves and Surplus' on the liabilities side of the Balance Sheet.

Also, section 52 of the Companies Act, 2013 states how a Company can use the Securities Premium. The following are the provisions regarding this:

1. The Company can use the amount towards the issue of un-issued shares to the

shareholders or members of the Company as fully paid bonus shares.

2. It can use this amount to write off the preliminary expenses.
3. The Company may use it to pay the premium on the redemption of debentures or redeemable preference shares.
4. It can also use this amount to write off the expenses incurred, commission paid or discount allowed on the issue of any securities or debentures.
5. It can also use it for buy-back of own shares or any other securities.

9 Debentures- Meaning & Features

Debenture is used to issue the loan by government and companies. The loan is issued at the fixed interest depending upon the reputation of the companies. When companies need to borrow some money to expand themselves they take the help of debentures.

The word 'debenture' itself is a derivation of the Latin word 'debere' which means to borrow or loan. Debentures are written instruments of debt that companies issue under their common seal. They are similar to a loan certificate.

Debentures are issued to the public as a contract of repayment of money borrowed from them. These debentures are for a fixed period and a fixed interest rate that can be payable yearly or half-yearly. Debentures are also offered to the public at large, like equity shares. Debentures are actually the most common way for large companies to borrow money.

Features of debentures

- Debentures are instruments of debt, which means that debenture holders become creditors of the Company
- They are a certificate of debt, with the date of redemption and amount of repayment mentioned on it. This certificate is issued under the Company seal and is known as a Debenture Deed
- Debentures have a fixed rate of interest, and such interest amount is payable yearly or half-yearly
- Debenture holders do not get any voting rights. This is because they are not instruments of equity, so debenture holders are not owners of the Company, only creditors
- The interest payable to these debenture holders is a charge against the profits of the Company. So these payments have to be made even in case of a loss.

Advantages of Debentures

- One of the biggest advantages of debentures is that the Company can get its required funds without diluting equity. Since debentures are a form of debt, the equity of the Company remains unchanged.
- Interest to be paid on debentures is a charge against profit for the Company. But this also means it is a tax-deductible expense and is useful while tax

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planning

- Debentures encourage long-term planning and funding. And compared to other forms of lending debentures tend to be cheaper.
- Debenture holders bear very little risk since the loan is secured and the interest is payable even in the case of a loss to the Company
- At times of inflation, debentures are the preferred instrument to raise funds since they have a fixed rate of interest

10 Difference between Shares & Debentures

Basis	Shares	Debentures
Meaning	Small portions of a Company's capital	Long term debt instruments that a Company issues in under its seal
Nature of capital	Owned capital	Borrowed capital
Investors	Shareholders are part owners of the Company	Debenture holders are creditors to the Company
Voting rights	Yes	No
In case of liquidation	Shareholders are given last priority	Creditors(debenture holders) are paid off first
Convertibility	Shares cannot be converted into debentures	Debentures can be converted into shares
Trust Deed	Trust deed is not carried out in the shares.	When the debentures are circulated to the public, a trust deed has to be carried out.

11 Types of Debentures

There are various types of debentures that a Company can issue, based on security, tenure, convertibility etc. Let us take a look at some of these types of debentures.

- ***Secured Debentures***: These are debentures that are secured against the assets of a Company. This means a charge is created on such an asset in case of default in repayment of such debentures. So in case, the Company does not have enough funds to repay such debentures, the said asset will be sold to pay such a loan. The charge may be fixed, i.e. against a specific assets or floating, i.e. against all assets of the firm.
- ***Unsecured Debentures:*** These are not secured by any charge against the assets of the Company, neither fixed nor floating. Normally such kinds of debentures are not issued by Companys in India.
- ***Redeemable Debentures***: These debentures are payable at the expiry of their term. Which means at the end of a specified period they are payable, either in the lump sum or in installments over a time period. Such debentures can be redeemable at par, premium or at a discount.

- ***Irredeemable Debentures***: Such debentures are perpetual in nature. There is no fixed date at which they become payable. They are redeemable when the Company goes into the liquidation process. Or they can be redeemable after an unspecified long time interval.
- ***Fully Convertible Debentures***: These shares can be converted to equity shares at the option of the debenture holder. So if he wishes then after a specified time interval all his shares will be converted to equity shares and he will become a shareholder.
- ***Partly Convertible Debentures:*** Here the holders of such debentures are given the option to partially convert their debentures to shares. If he opts for the conversion, he will be both a creditor and a shareholder of the Company.
- ***Non-Convertible Debentures***: As the name suggests such debentures do not have an option to be converted to shares or any kind of equity. These debentures will remain so till their maturity, no conversion will take place. These are the most common type of debentures.

12 Issue of Debentures

The issue of Debentures is very similar to the issue of shares by a Company. Here to the money can be collected lump sum or in installments. The accounting treatment of the two is also quite similar. Now debentures can be issued for cash or some other consideration. At times issue of debentures is also done as a collateral security

Issue of Debentures for Cash

Debentures in the general course of business are issued for cash. This issue of debentures that happens can be of three kinds, just like an issue of shares, at par, at a discount, and at a premium. So let us take a look at all three and their respective accounting entries as well.

- ***Issue at Par***

  Here the debentures will be issued exactly at their nominal price, i.e. not above or below the face value of the debentures. Now the Company can decide to collect the cash all at once, in a lump sum. Or the money will be collected in installments, like with allotment, first call, second call, last call etc.

- ***Issue at Discount***

  When the debentures are issued at below face value, such issue of debentures is known as a discount issue. For example the debenture has a nominal value of 100 but is issued for 85. Then such debentures are said to be issued at discount.

  Discount on issue of debentures is treated as a capital loss and put under "Miscellaneous Expenses" on the asset side of the balance sheet until it can be written off. Then during the life of the debentures, such discount amount is written off by debiting it to the Profit and Loss A/c. It can also be charged against the Capital Profits of the Company.

- ***Issue at Premium***

  It is when more money than the nominal value is charged. So if a debenture with a face value of 100 is sold at 115 then it is issued at a premium. The amount of the

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premium is charged to a special account known as Securities Premium Reserve Account. This account will be shown on the liabilities side of the Balance Sheet under the heading of Reserves and Surplus.

Debentures are said to be issued at par when their issue price is equal to the value. The journal entries recorded for such issues are as under:

a) If whole amount is received in one instalment:

i) On receipt of the application money Bank A/c Dr.

To Debenture Application & Allotment A/c

ii) On Alloment of debentures

Debenture Application & Allotment A/c Dr.

To Debentures A/c

b) If debenture amount is received in two instalments:

i) On receipt of application money

Bank A/c Dr.

Debentur Application A/c

ii) For adjustment of applications money on allotment

Debenture Application A/c Dr.

To Debentures A/c

iii) Forallotment money due

Debenture Allotment A/c Dr.

To Debentures A/c

iv) On receipt of allotment money

Bank A/c Dr.

To Debenture Allotment A/c

c) If debenture money is received in more than two instalments Additional entries:

i) On making the first call

Debenture First Call A/c Dr.

To Debentures A/c

ii) On the receipt of the first call

Bank A/c Dr.

To Debenture First Call A/c

Note: Similar entries may be made for the second call and final call. However, normally the whole amount is collected on application or in two instalments, i.e., on application and allotment.

13 Issue of Debentures in Consideration Other than for Cash

Debentures can be issued for non-cash considerations. The Company may have purchased assets from some vendors or acquired some other business. Then instead of paying cash, the Company may issue debentures to such vendors. Such an issue for debentures can be at par, or for a discount or at a premium.

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14 Issue of Debentures as Collateral Security

Debentures can also be issued by a Company as collateral security against a bank loan or any such borrowings. A collateral security is like a parallel security which is provided along with the actual security against the loan taken. Debentures issued as such a collateral liability are a contingent liability for the Company, i.e. the liability may or may not arise. Only when the Company defaults on such a loan will this liability arise.

Generally, because it is a contingent liability no entry is passed in the books of the Company against such an issue of debentures

Key Takeaways:

- ***Nominal Capital***: Authorised capital of a company.
- ***Shareholder***: A person having a share is called a shareholder and has ownership security
- ***Convertible Shares***: Share that can be easily converted. Actual Payment – Real payment and not the assumed one.
- ***Allotment of Shares*** – Allocation of shares in a company.
- ***Par Value*** – Nominal or reasonable value.
- ***Premium*** – A sum added to an ordinary price.
- ***Buy-Back***: To buy that is previously sold.
- ***Subsidiary Company***: Company that is completely controlled by another company.
- ***Discount at Issues***: The discount from par value at the time that a bond is issued.
- ***Forfeiture of Shares***: A share in a company that the owner loses (forfeits) by failing to meet the purchase requirements.
- ***Share Capital Account*** - Funds raised by issuing shares in return for cash or other considerations.
- ***Convertible Debentures***: Those debentures which can be converted into shares of the company on certain dates, or during a certain period at the option of the debenture-holder according to the terms of issue.
- ***Debenture Holder***: A person having a debenture is called a debenture-holder, who is creditor of the company.
- ***Debenture***: A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral.
- ***First Debentures***: Those debentures that are to be repaid and on which interest is to be paid in priority to other debentures, are called first debentures.
- ***Non-convertible Debentures***: Those debentures whose debenture-holders do not have a right to convert them into equity or preference debentures.

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- ***Redeemable Debentures***: These are those debentures which are redeemed/ repaid either at the expiry of a specific period or within a period by the company.

Check your progress:

1. According to which section a company is defined?
   a) Section 2(10)
   b) Section 2(20)
   c) Section 4(20)
   d) Section 5(20)
2. The minimum number of members in a private limited company is
   a) 2
   b) 3
   c) 5
   d) 7
3. ________________ portion of the issued capital which has been subscribed for by the purchasers of the Company's shares
   a) Issued Capital
   b) Subscribed Capital
   c) Called up capital
   d) Share Capital
4. According to which section a share is defined?
   a) Section 2(84)
   b) Section 2(20)
   c) Section 4(84)
   d) Section 5(51)
5. _________________ is the value given or mentioned on the certificate of share
   a) Nominal Value
   b) Premium Value
   c) Discount Value
   d) Par Value

Questions & Exercises

1. Describe the company and its types.
2. Describe shares and its types.
3. What is subscription of shares?
4. What is share capital?
5. Differentiate between public and private company

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Check your progress:

1. b) Section 2(20)
2. a) 2
3. b) Subscribed Capital
4. a) Section 2(84)
5. d) Par Value

Further Readings

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